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PUERTO RICO STATUS REFERENDUM ACT

SEPTEMBER 30 (legislative day, SEPTEMBER 10), 1990.—Ordered to be printed

Mr. BENTSEN, from the Committee on Finance, submitted the following

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REPORT

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[To accompany the Committee amendments to S. 712]

[Including cost estimate of the Congressional Budget Office]

The Committee on Finance, to which was referred the bill (S. 712) to provide for a referendum on the political status of Puerto Rico, as reported by the Committee on Energy and Natural Resources (Report 101-120), having considered the same, reports favorably amendments thereto. The Committee makes no recommendation on whether the bill as amended by the Committee do pass.

I. LEGISLATIVE BACKGROUND

S. 712 was introduced in the Senate on April 5, 1989, and referred to the Committee on Energy and Natural Resources. S. 712 was reported by that Committee on September 6, 1989 (S. Rept. No. 101-120). S. 712 was jointly referred to the Senate Committees on Finance and on Agriculture, Nutrition, and Forestry. The Committee on Finance held hearings on the bill on November 14-15, 1989 and April 26, 1990. On August 1, 1990, the Committee on Finance marked up its amendment to S. 712 as previously reported by the Committee on Energy and Natural Resources.

The purpose of S. 712 is to provide for the exercise of self-determination by the people of Puerto Rico through a referendum on the future political status of the island. Title I sets forth the legal framework and timing of the referendum. Titles II, III, and IV set forth detailed definitions of the three respective status options: statehood, independence, and commonwealth. The option which receives a majority vote in the referendum would be implemented in accordance with the appropriate title of S. 712.

The bill reported by the Committee on Energy and Natural Resources is self-implementing; that is, once the results of the referendum are certified as being in favor of one of the three options, no further action by Congress is necessary to permit that option to be implemented. Moreover, many of the U.S. laws now affecting Puerto Rico would be amended under the bill as referred to the Committee on Finance, upon certification of the referendum results, to take account of the option chosen. The laws that would be amended by the bill as so referred include laws the amendment of which is within the jurisdiction of the Committee on Finance (e.g., tax, trade, and social security laws).

The Committee on Finance amendment reflected in this report replaces those provisions of the bill referred to the Finance Committee that are within the jurisdiction of the Finance Committee. In addition, where a bill provision relates to matters both within and without the Finance Committee's jurisdiction, the amendment reported herein provides modifications with respect to matters within the Finance Committee's jurisdiction.

The Committee on Finance recommends that if the Senate passes S. 712, the Finance Committee amendment should be adopted. However, the Finance Committee takes no position on whether the provisions of S. 712 as amended herein should or should not be passed. For example, while the Finance Committee endorses the principle of self-determination for the people of Puerto Rico, the Finance Committee takes no position on whether a law providing for a Puerto Rico status referendum should be self-executing, as S. 712 currently would provide.

II. Explanation of the Committee Amendment

A. PRESENT LAW

1. Tax Rules [1]

Taxation of individuals

U.S. residents and citizens in general

The United States generally imposes income tax on the worldwide income of U.S. citizens and residents. All U.S. citizens and residents whose gross income for a taxable year is not less than the sum of the personal exemption amount and the basic standard deduction are required to file an annual U.S. individual income tax return.

Nonresident alien individuals are subject to U.S. tax, at ordinary rates, on their net income effectively connected with the conduct of a trade or business in the United States. Such individuals are also subject to a tax (at different rates computed on the basis of gross income) on certain other types of U.S. source income. Generally, Puerto Rico is not included within the United States for purposes of the Internal Revenue Code.

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[1] For a more detailed description of present-law tax rules, S. 712 as reported by the Senate Committee on Energy and Natural Resources, and related issues, see Joint Committee on Taxation, "Tax Rules Relating to Puerto Rico Under Present Law and Under Statehood, Independence, and Enhanced Commonwealth Status" (S. 712, Puerto Rico Status Referendum Act) (JCS-19-89), November 14, 1989.

Treatment of foreign source income

In general, U.S. persons (e.g., U.S. residents and U.S. citizens no matter where they reside) are taxed on all their income whether from U.S. or foreign sources. A credit, with limitations, may be claimed under Code sections 901–907 for foreign income taxes paid or accrued, or alternatively foreign taxes may be treated as a deduction. For purposes of the Code, Puerto Rico generally is treated as a foreign country, with significant exceptions discussed below.

Code section 911 provides that a U.S. citizen or resident with a tax home abroad may under certain circumstances elect to exclude an amount of foreign earned income from gross income. The maximum exclusion generally is limited to $70,000 per year plus certain housing costs. No deductions, exclusions, or credits are allowed for amounts allocable to this excluded income.

Taxation of U.S. persons residing in Puerto Rico

Under the Jones Act, Puerto Rico is deemed to be a part of the United States for purposes of acquiring U.S. citizenship by place of birth. Thus, a person born in Puerto Rico is typically a U.S. person for U.S. tax purposes. However, section 933 of the Code provides that income derived from sources within Puerto Rico by an individual who is a resident of Puerto Rico generally will be excluded from gross income and exempt from U.S. taxation, even if such resident is a U.S. citizen. Such income generally will be subject to taxation by Puerto Rico. Items of income earned from sources outside of Puerto Rico by U.S. persons who reside in Puerto Rico generally are subject to U.S. taxation.

Estate and gift tax

Under a special rule, a U.S. citizen residing in a possession is treated as a nonresident alien for estate and gift tax purposes only if citizenship was acquired solely by reason of citizenship of, or birth or residence within, the possession. This rule generally exempts all transfers by such citizens of property situated outside the United States from U.S. estate and gift taxation. Estates of decedents qualifying under this rule are allowed a credit against the estate tax equal to the greater of $13,000 or that proportion of $46,800 which the value of that part of the decedent's gross estate which at the time of death was situated in the United States bears to the value of the entire gross estate wherever situated. Estate and gift transfers by residents of Puerto Rico of property located in Puerto Rico generally are not subject to estate and gift taxation in Puerto Rico.

Taxation of corporations

Puerto Rico corporations

A corporation organized under the laws of Puerto Rico is a foreign corporation and is subject only to those U.S. taxes imposed on foreign corporations in general. However, Puerto Rico corporations generally are subject to income taxes in Puerto Rico. Currently, the minimum rate is 22 percent, and the highest marginal rate for 1990 is 39 percent, for 1991 is 37 percent, and for 1992 and beyond is 35 percent.

U.S. corporations—in general

U.S. corporations are subject to U.S. income tax on their worldwide income. Foreign income taxes paid or accrued are creditable, with limitations, against U.S. tax liability or alternatively may be deducted in calculating taxable income. Special rules apply to income derived in U.S. possessions by certain domestic corporations.

Possession tax credit (sec. 936)

Under present law, certain domestic corporations with business operations in U.S. possessions (including, for this purpose, Puerto Rico and the U.S. Virgin Islands) may elect under Code section 936 to generally eliminate the U.S. tax (including the alternative minimum tax) on certain foreign source income which is related to their operations in the possessions. Currently, a majority of corporations that benefit from the possession tax credit have established operations in Puerto Rico. Income that is not subject to U.S. tax under this provision includes income that is derived either from the active conduct of a trade or business within a U.S. possession or from certain investments in the possessions or in certain Caribbean Basin countries, which investments generate qualified possession source investment income ("QPSII"). The section 936 credit spares the electing corporation U.S. tax whether or not it pays income tax to the possession.

In order to qualify for the section 936 credit, a domestic corporation must derive at least 75 percent of its gross income from the active conduct of a trade or business within a U.S. possession over a three-year period, and at least 80 percent of the corporation's gross income must be derived from sources within a possession during that same period.

Three alternative methods are provided for allocating income from intangible property between a corporation electing section 936 treatment and its U.S. shareholders. These methods include (1) a general rule that prohibits an electing corporation from earning any return on intangible property, (2) a cost sharing method which requires an electing corporation to reimburse other members of its affiliated group of corporations for a portion of the current research and development expenses incurred by the group, and (3) a profit split approach which generally permits no more than 50 percent of an affiliated group of U.S. corporations' combined taxable income derived from sales of products which are manufactured in a U.S. possession to be allocated to the electing corporation. For purposes of computing the cost sharing amount under the cost sharing method, an electing corporation's current share of the affiliated group's research and development expenses is the greater of the total amount of such expenses in the electing corporation's product area multiplied by 110 percent of the proportion of its sales as compared to total product area sales of the group, or the amount of the royalty payment or inclusion that would be required under sections 367(d) and 482 with respect to intangible assets which the electing corporation is treated as owning under the cost sharing method, were the electing corporation a foreign corporation.

Dividends paid by a corporation that has elected section 936 treatment to its U.S. shareholder may qualify for the deduction for dividends received from a domestic corporation (sec. 243). In cases where at least 80 percent of the stock of the electing corporation is owned by a single domestic corporation, the electing corporation's possession source income generally can be distributed without incurring any regular U.S. income tax. However, such a dividend constitutes adjusted current earnings of the shareholder for purposes of computing the alternative minimum tax.

U.S. taxation of Puerto Rico obligations

Section 103 of the Code provides that the interest on a bond issued by the Commonwealth of Puerto Rico or its municipalities generally is exempt from U.S. income tax in the same manner as interest on a bond issued by a State. The exemption does not apply to any bond that is a non-qualified private activity bond (within the meaning of sec. 141).

Low-income housing credit

A low-income housing credit is allowed against U.S. income tax liability. The credit is allowed in annual installments over 10 years to the owners of qualified low-income rental housing, including housing located in a U.S. possession. In addition to maintaining prescribed percentages of low-income units and satisfying other requirements, the building owners must receive a credit allocation from the appropriate credit authority (such as a State or Puerto Rico), except in the case of housing projects financed with tax-exempt bonds. In general, the authority of housing credit agencies to allocate low-income housing credits expires December 31, 1990.

Excise taxes

U.S. excise taxes on Puerto Rican goods imported into the United States

U.S. excise taxes generally do not apply within Puerto Rico. However, U.S. excise taxes equal to the taxes on domestically produced articles are imposed on articles brought into the United States from Puerto Rico.

Cover overs of excise taxes on Puerto Rican products

Revenues collected from the excise taxes on certain articles coming into the United States from Puerto Rico generally are "covered over" (i.e., paid) to the Puerto Rican Treasury. With respect to otherwise eligible excise taxes imposed on articles not containing distilled spirits, revenues are covered over to Puerto Rico only if the cost or value of materials produced in Puerto Rico plus the direct costs of processing operations performed in Puerto Rico equal at least 50 percent of the value of the article at the time it is brought into the United States (sec. 7652(d)(1)). Moreover, no cover over is permitted on such articles if Puerto Rico provides a direct or indirect subsidy with respect to the article which is unlike the subsidies which Puerto Rico generally offers to industries producing articles not subject to Federal excise tax (sec. 7652(d)(2)).

With respect to Federal excise taxes imposed on articles containing distilled spirits that are manufactured in Puerto Rico and shipped into the United States, revenues are covered over to the Puerto Rican Treasury only if at least 92 percent of the alcoholic content of such articles is attributable to rum (sec. 7652(c)). The amount of excise taxes covered over to Puerto Rico from such articles cannot exceed $10.50 per proof gallon (sec. 7652(f)).[2]

A special excise tax rule also applies when articles manufactured in the United States are shipped to Puerto Rico (sec. 7653). In such cases, the articles are exempt from Federal excise taxes and, upon being entered in Puerto Rico, are subject to a tax equal in rate and amount to the excise tax imposed in Puerto Rico upon similar articles of Puerto Rican manufacture.

Cover overs of excise taxes on rum imported from other countries

A provision of the Code added by the Caribbean Basin Economic Recovery Act (Caribbean Basin Initiative) provides a special rule for excise taxes collected on rum imported into the United States from any country. Such excise taxes are covered over to the treasuries of Puerto Rico and the Virgin Islands, under a formula prescribed by the U.S. Treasury Department for the division of such tax collections between Puerto Rico and the Virgin Islands (sec. 7652(e)). This formula currently results in approximately 88 percent of revenues from excise taxes on imported rum being covered over to Puerto Rico and the remainder of such revenues being covered over to the Virgin Islands.

Tax treaties

There are no bilateral tax treaties between Puerto Rico and any foreign country. In addition, U.S. treaties typically do not include Puerto Rico in the definition of "United States" for treaty purposes. Moreover, although Puerto Rican individuals are typically U.S. citizens, U.S. treaties often do not extend to them the same reductions of foreign source country tax to which a resident of one of the 50 States or the District of Columbia would be entitled under a U.S. tax treaty.

Uniformity clause

The U.S. Constitution grants to the Congress the power to lay and collect "Taxes, Duties, Imposts and Excises, . . . but all Duties, Imposts and Excises shall be uniform throughout the United States." [3] As indicated by the absence of the word "taxes" from the clause setting forth the rule of uniformity (the "uniformity clause"), the rule applies only to the subset of taxes encompassed by the terms "duties, imposts and excises." In the Committee's

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[2] The current Federal distilled spirits excise tax rate is $12.50 per proof gallon.

[3] U.S. Const., art. I, sec. 8, cl. 1. There is no equivalent limitation on the spending power of Congress. *See, e.g., Helvering* v. *Davis*, 301 U.S. 619 (1937) (Congress has discretion to determine that the general welfare is served by an expenditure program that addresses local problems).

view, it may be fairly argued that the Federal income tax is subject to the requirements of the uniformity clause.[4]

Puerto Rico is not considered to be part of the United States for purposes of the scope of the uniformity clause.[5] Accordingly, under the present status of Puerto Rico, Congress is free to adopt tax measures (such as Code section 936) that are not uniform as between Puerto Rico, on the one hand, and the 50 States and the District of Columbia, on the other. Through the exercise of its power to admit Puerto Rico as a new State, however, Congress may voluntarily bring Puerto Rico within the scope of the uniformity requirement.

According to Justice Story, the purpose of the uniformity clause

> * * * was to cut off all undue preferences of one State over another in the regulation of subjects affecting their common interests. Unless duties, imposts, and excises were uniform, the grossest and most oppressive inequalities, vitally affecting the pursuits and employments of the people of different States, might exist. The agriculture, commerce, or manufactures of one State might be built up on the ruins of those of another; and a combination of a few States in Congress might secure a monopoly of certain branches of trade and business to themselves, to the injury, if not to the destruction, of their less favored neighbors.[6]

Other experts, scholars and judges have concurred.

The uniformity clause does not require that all affected taxes fall equally or proportionately on each State or region. The clause requires only that a tax operate "with the same force and effect in every place where the subject of it is found." [7] Similarly, in the case of the uniformity requirement of the bankruptcy clause,[8] "[t]he uniformity provision does not deny Congress power to take into account differences that exist between different parts of the country, and to fashion legislation to resolve geographically isolated problems." [9]

Most recently, in *United States* v. *Ptasynski*,[10] the Supreme Court held that an exception for certain Alaskan crude oil from the Crude Oil Windfall Profit Tax Act of 1980 did not violate the tax uniformity clause. That Act was "designed to impose relatively high tax rates where production cannot be expected to respond

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[4] *Compare Pollock* v. *Farmers' Trust and Loan Co.*, 157 U.S. 429 (1895) (classified a tax on income from real property or invested personal property by reference to the source of the income and characterized such a tax as equivalent to a tax on real property, which is outside the scope of the uniformity clause), *with Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911), (a tax on corporations measured by income is an excise on the privilege of doing business in the corporate form, and is thus subject to the requirement of uniformity), *and Brushaber v. Union Pacific Railroad Co.*, 240 U.S. 1, 19 (1916) (the sixteenth amendment prevents the classification of an income tax by reference to the source of the income, which could "take an income tax out of the class of excises, duties, and imposts").

[5] *Downes v. Bidwell*, 182 U.S. 245 (1901); *see also Balzac v. Porto Rico*, 258 U.S. 298 (1922).

[6] 1 J. Story, "Commentaries on the Constitution of the United States" sec. 957 (T. Cooley ed. 1873), cited in United States v. Ptasynski, 462 U.S. 74, 81 (1983).

[7] "Head Money Cases," 112 U.S. 580, 594 (1884) (upholding as uniform a tax on immigrants through seaports but not on immigrants through inland cities).

[8] U.S. Const., art. I, sec. 8, cl. 4.

[9] *Regional Rail Reorganization Act Cases*, 419 U.S. 102, 159 (1974).

[10] 462 U.S. 74 (1983).

very much to further increases in price and relatively low tax rates on oil whose production is likely to be responsive to price." [11] To that end, Congress exempted certain classes of oil from the tax, including a relatively limited subset of the oil produced in Alaska, denoted "exempt Alaskan oil." Exempt Alaskan oil was defined geographically, by reference to the Arctic Circle and the Alaska-Aleutian Range.

The exemption reflected the considered judgment of Congress that unique climatic and geographic conditions required that oil produced from a specified area be treated as a separate class of oil.[12] The Supreme Court found that Congress had before it ample evidence of the disproportionate costs and difficulties associated with extracting oil from this region. The Court stated that it could not fault the determination of Congress, based on neutral factors, that this oil required separate treatment.[13] Nor was there any evidence that Congress sought to benefit Alaska for reasons that would offend the purposes of the uniformity clause (for example, by intending to grant Alaska an undue preference at the expense of other oil-producing States), especially in view of the fact that the tax generally fell heavily on Alaskan oil.[14] Accordingly, the exemption was held not to violate the uniformity clause.

The Supreme Court in *Ptasynski*, following the analysis of the *Regional Rail Reorganization Act Cases* decision, opined that the uniformity clause gives Congress wide latitude in deciding what to tax, and does not prevent Congress from considering geographically isolated problems. Identifying the subject of a tax in terms of its geographic boundaries does not render the tax invalid, but rather triggers a close examination of the classification to see if there is prohibited discrimination in light of the purposes of the uniformity clause.[15]

The Committee is not aware of any authority under the uniformity clause that directly considers whether a temporary nonuniformity would violate the clause. However, in *Coyle v. Smith*,[16] the Supreme Court did invalidate a transition provision in the 1906 enabling act under which Oklahoma was admitted as a State, which provision would have prevented Oklahoma from removing its capital from the city of Guthrie, Oklahoma, until 1913. The Court noted that the power to locate its own seat of government and to determine when and how it shall be changed from one place to another are "essentially and peculiarly state powers" of which the original 13 states could not later have been deprived by an act of Congress.[17] The Court then held that the authority to admit new States did not permit Congress to impose a condition on the admission of a new State that would deprive the new State of such a power possessed by the pre-existing States. The Court invalidated the statutory limitation on removal of the state capital from Guthrie despite its temporary nature. The Court's opinion contains no

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[11] H.R. Rep. No. 96-304, 96th Cong., 2d Sess. 7 (1980), cited in *Ptasynski*, 462 U.S. at 77.
[12] H.R. Rep. No. 96-817, 96th Cong., 2d Sess. 103 (1980).
[13] 462 U.S. at 85.
[14] *Id.* at 77 n.5.
[15] *Id.* at 85.
[16] 221 U.S. 559 (1911).
[17] *Id.* at 565.

discussion of the temporary nature of that limitation, or of the constitutional significance (or insignificance) of that fact.

2. Trade Law Rules

Under present law, Puerto Rico is part of the customs territory of the United States. Thus, trade between Puerto Rico and the 50 states is domestic in nature, and is not subject to tariffs or any restrictions or requirements applicable to trade with foreign countries. Likewise, trade between Puerto Rico and foreign countries is generally governed, with limited exceptions, by the same U.S. trade laws applicable to U.S. trade with foreign countries. Imports into Puerto Rico are subject to U.S. duties and trade restrictions, and all obligations of the United States under bilateral and multilateral trade agreements, including the GATT, apply to Puerto Rico's trade.

In three respects, however, U.S. trade laws provide special treatment for Puerto Rico. First, all import duties collected in Puerto Rico, less the cost to the U.S. Customs Service of collecting the duties, are paid to Puerto Rico, rather than retained by the Federal Treasury. Second, Puerto Rico is authorized by statute to impose its own duty on coffee, whether imported directly into Puerto Rico or through the United States. Third, although Puerto Rico is not an eligible country under the Caribbean Basin Economic Recovery Act (CBERA), the CBERA includes specific provisions relating to the treatment of Puerto Rico content in determining whether a product qualifies for duty-free treatment under CBERA. Thus, Puerto Rico benefits indirectly from trade preferences accorded to eligible Caribbean countries.

3. Social Security Act Spending Program Rules

Old Age, Survivors, and Disability Insurance (OASDI)

This basic social security program operates in Puerto Rico under essentially the same rules and conditions as apply elsewhere in the United States.

Medicare

Medicare eligibility and benefits are the same for social security beneficiaries in Puerto Rico as in the States. However, hospitals are reimbursed under a separate prospective payment schedule which results in a generally lower reimbursement than would apply to a hospital in the States for the same procedure. A substantial proportion (35 percent) of the Medicare eligible population has not elected coverage under Part B of medicare.

Unemployment compensation

Puerto Rico is treated as a State for purposes of the Federal-State program of unemployment compensation. As in the States, benefit levels are set by the "State" government and regular benefits are funded by "State" payroll taxes on employers. Because of chronic high unemployment, Puerto Rico (unlike nearly all States) is frequently triggered onto the extended benefits program which provides an additional 13 weeks of benefits funded half from Com-

monwealth payroll taxes and half from the Federal unemployment tax.

Aid to the aged, blind, and disabled

In the States, needy aged, blind, and disabled individuals receive Federal payments under the Supplemental Security Income (SSI) program sufficient to maintain their income at a level of $386 per month for an individual and $579 for a couple. (These are the 1990 rates; these amounts are increased annually for inflation.) In a number of States, higher levels are provided through supplementary State-funded payments. The SSI program does not apply to residents of Puerto Rico. Instead, a program of aid to the aged, blind, and disabled is operated with Commonwealth and Federal funds. A combined Federal funding limit of $82 million annually applies to this program and to the Aid to Families with Dependent Children program. Assistance levels are determined by the Government of Puerto Rico. For an aged, blind, or disabled individual with average shelter costs and no other income, the monthly assistance payment would be about $42. In addition, such an individual would typically receive a monthly payment from the Nutrition Assistance Program—which operates in place of the Food Stamp Program—of roughly $75.

Aid to Families with Dependent Children (AFDC)

In the States and in Puerto Rico, assistance is provided under a program of Aid to Families with Dependent Children (AFDC) pursuant to title IV of the Social Security Act. Assistance levels are set by each State, and funding is shared between the State and the Federal Government. In the States, funding is available on an open-ended basis with Federal matching rates ranging from 50 to 83 percent depending on State per capita income. In Puerto Rico, there is a maximum Federal matching rate of 75 percent but Federal funding is actually controlled by the $82 million Federal funding cap which jointly covers this program and the program of Aid to the Aged, Blind, and Disabled. The 1990 maximum AFDC payment for a 3-person family in Puerto Rico is $90. Such a family would typically also receive a payment of roughly $200 under the Nutrition Assistance Program.

Medicaid

In the States, recipients of assistance under the SSI and AFDC programs along with certain other eligible individuals are entitled to have their medical costs paid by medicaid programs established under State plans in accord with the requirements of title XIX of the Social Security Act. Federal funding is provided on an open-ended basis at rates generally ranging from 50 to 83 percent depending on State per capita income. Recipients generally are free to select any medical provider of their choice. In Puerto Rico, the medicaid program as it is understood in the States does not exist. Instead, Puerto Rico operates a system of public health facilities which are available to the population generally. The Federal Government reimburses Puerto Rico under the medicaid program at a theoretical 50 percent matching rate. In practice, Federal matching

is controlled by an overall cap on annual Federal funding which is set at $79 million.

Title XX social services program

Under title XX of the Social Security Act, a block grant is made to States to help them provide a wide variety of social services. Great flexibility is left to the States to determine what services will be funded with these grants. The national funding level for this program is $2.8 billion per year and each State receives a share of that total on the basis of its relative population. Puerto Rico receives title XX funds under a separate formula. Under the population formula Puerto Rico would qualify for about $35 million rather than the approximately $15 million it receives under the current formula.

Other programs

The Child Welfare Services and Child Support enforcement programs operate in Puerto Rico generally as in the States. The Foster Care and Adoption Assistance program is not implemented in Puerto Rico. Puerto Rico is eligible to participate in this program but would receive no additional Federal funding since the $82 million cap on Federal funding for AFDC and aid to the aged, blind, and disabled also covers this program. Present law appears to mandate Puerto Rico participation in this program, but this mandate has never been enforced.

B. REASONS FOR CHANGE

In general

The Finance Committee amendments are intended to be consistent with five broad principles.

First, the Committee believes that, to the extent possible, each individual's choice among the three political status options should not be colored by differing personal financial consequences of the three options. Rather, the Committee believes that each voter's choice should be, to the extent possible, an expression of his or her preference concerning the nature of Puerto Rico's fundamental relationship to the United States. Second, the Committee believes that the changes provided for under the amendment should be accomplished gradually in order to avoid disruption and to allow for a period of transition without which abrupt and undesirable economic, social, and political consequences might result. Third, the Committee seeks to avoid a negative U.S. Federal budgetary impact from the amendment provisions.

Two other general criteria to which the Committee has sought to adhere relate specifically to the provisions that would apply if the people of Puerto Rico choose to change Puerto Rico's status to statehood or independence. First, the Committee has designed the amendment so that, if statehood is chosen, Puerto Rico will be treated in all respects, after the date of admission to statehood, on an equal footing with the other States with respect to all matters within the jurisdiction of the Finance Committee. Second, the Finance Committee intends that, if independence is chosen, careful consideration be given to the nature of the future relationship be-

tween the United States and an independent Puerto Rico. For example, the Committee believes that the United States should continue to maintain an open trading relationship with an independent Puerto Rico, and that, at a minimum, Puerto Rico should receive most-favored-nation trade treatment. Furthermore, the Committee believes that, if Puerto Rico becomes an independent nation, consideration should be given to designation of Puerto Rico as a beneficiary country under the Caribbean Basin Economic Recovery Act and the negotiation of a free trade agreement between the United States and Puerto Rico.

Even playing field

Under present law, Federal social welfare programs under the Social Security Act such as AFDC, Medicaid, Aid to the Aged, Blind, and Disabled, Foster Care and Adoption Assistance, and Social Services block grant operate differently in Puerto Rico than they do in the States. Under statehood, both the amount of the welfare benefits and the percentage of the population receiving them would substantially increase. The Committee is concerned that the prospect of increased benefits under statehood should not be a substantial factor in determining how Puerto Rican individuals vote in the referendum.

The Committee believes that in order to achieve the Committee's goal of providing an even playing field in the people's choice between the two options that retain Puerto Rican participation in these Federal spending programs (statehood and commonwealth), it is necessary to enhance certain social spending programs in Puerto Rico if continued commonwealth status is chosen. Thus with respect to the social welfare programs under Finance Committee jurisdiction, the Committee has designed enhancements with the intention of achieving a high degree of parity between the benefits available under commonwealth and the benefits that would be available under statehood both during the transition period and upon full implementation.

In connection with this bill, the Committee reexamined the parameters of the SSI and aid to the aged, blind, and disabled programs applicable generally under current law. The Committee believes that it is appropriate to limit the amount of benefits for the aged, blind, and disabled under the Supplemental Security Income program of the Social Security Act to no more than 50 percent of per capita income in the beneficiary's state of residence. To permit such benefits to exceed that amount could create adverse economic incentives, and generally would be unreasonable in light of wage levels and other public expenditure patterns. Under current law SSI benefits do not exceed 50 percent of per capita income in any state. However, current law as applied to a State of Puerto Rico would result in a benefit level for an individual under SSI approximately equal to 90 percent of the per capita income of Puerto Rico. Such a standard would greatly expand the number of individuals dependent upon assistance payments in Puerto Rico, and produce the undesirable results described above. Thus, the Committee believes that it is more appropriate to limit the amount of benefits available in any State to no more than a fixed fraction of per capita State income.

Gradual transition

On the basis of the record before it, the Committee understands that the tax incentives provided under section 936 have a major impact on the economy of Puerto Rico.[18] In 1987, total employment in Puerto Rico was approximately 834,000 and gross domestic product totalled $23.7 billion.[19] Nearly $2.7 billion of tax benefits were utilized under section 936 in 1987.[20] The large majority of section 936 corporations were engaged in manufacturing.[21] These manufacturing corporations employed almost 89,000 workers in 1983, approximately 68 percent of total manufacturing employment in Puerto Rico in that year.[22] In testimony before the Committee, the Treasury Department reported that section 936 corporations accounted for 12 percent of total employment and 16 percent of total labor income in Puerto Rico.[23] As of November 27, 1989, $10.2 billion of funds were deposited in financial institutions in Puerto Rico by section 936 corporations.[24] Given the importance of section 936 tax benefits to the manufacturing and financial sectors of Puerto Rico, and given the size of economic activity by section 936 corporations relative to the overall economy of Puerto Rico, the Committee believes that significant economic disruption could occur if the benefits of section 936 were precipitously withdrawn from U.S. companies with Puerto Rico operations.

The Committee also believes that U.S. taxpayers may have relied on section 936 benefits in deciding to locate activities in Puerto Rico. The Committee believes that it is fair to provide a transition period for those companies to adjust to the elimination of that tax benefit.

For these reasons, the Committee believes that it is appropriate and necessary to provide a gradual phase-out of the section 936 benefit over a 5-year period following a vote for either statehood or independence. The Committee intends that section 936 credits be made available to a U.S. corporation under these rules during the transition period only if the taxpayer was previously operating under the credit and then only in an amount based on the taxpayer's prior utilization of the credit.

The Committee also understands that if statehood is chosen the people and the Government of Puerto Rico, the U.S. Internal Revenue Service, and the U.S. Department of Health and Human Services, may be required to make substantial adjustments upon application of the U.S. income tax system to Puerto Rico, increases in

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[18] See generally Joint Committee on Taxation, "Tax Rules Relating to Puerto Rico Under Present Law and Under Statehood, Independence, and Enhanced Commonwealth Status" (S. 712, Puerto Rico Status Referendum Act) (JCS–19–89), November 14, 1989, at 32–33, in "Puerto Rico's Political Status: Hearings on S. 712 Before the Senate Comm. on Finance," 101st Cong., 1st Sess. 75, 106–07 (1990).

[19] Puerto Rico Planning Board, "Economic Report to the Governor", 1989, Tables 1 and 29.

[20] Source Book, Statistics of Income 1987, Corporation Income Tax Returns, Department of the Treasury, Internal Revenue Service, Publication 1053 (Rev. 6–90).

[21] Of a total of $22.2 billion of section 936 corporation assets, $17.2 billion of assets were held by section 936 manufacturing corporations. See "The Operation and Effect of the Possessions Corporations System of Taxation," Sixth Report, U.S. Treasury Department, March 1989, Table 4–1.

[22] Ibid, Table 4–6, and op. cit., Puerto Rico Planning Board, Table 30.

[23] Testimony of Philip D. Morrison, International Tax Counsel, Department of the Treasury, Before the Committee on Finance of the United States Senate, Washington, D.C., April 26, 1990, p. 12.

[24] Report of Commissioner of Financial Institutions in Puerto Rico, November 27, 1989.

Puerto Rico social welfare program benefit levels, and increases in Federal grants to Puerto Rico under those programs. Therefore, the Committee believes it appropriate to phase up the tax payments owed by Puerto Rico residents to the United States in stages, in order to permit the Government of Puerto Rico to gradually adjust its own tax laws as it sees fit. Further, the Committee believes it appropriate to delay the start of the phase-in of U.S. tax treatment of Puerto Rico, and the phase-in of benefit program enhancements, for one year after certification of the referendum results for statehood.

Other provisions of the bill are intended to ease the transition to statehood or independence. For example, if statehood is chosen, the Committee believes it appropriate to phase out the import duty on coffee over four years beginning with the second year after certification of the referendum.

Budgetary effect

Under present law, U.S. companies doing business in Puerto Rico annually receive over $2 billion in tax benefits under the section 936 possession tax credit. Further, under present law hundreds of millions of dollars in amounts collected as taxes and customs duties by the United States are annually covered over to the Government of the Commonwealth of Puerto Rico.

The enhanced costs to the Federal Government resulting from the spending changes under the statehood option would be offset, in the Committee's view, by increased U.S. tax receipts and decreased U.S. tax cover over to Puerto Rico. Under the independence option, the Committee understands that while block grants will continue after Puerto Rico becomes a separate country, there will be no Federal budgetary loss due to the phase-out of the section 936 credit.

Under the commonwealth option, the Committee believes it is appropriate to offset the costs of increased Federal spending (dictated by the reasons described above in the section entitled "Even playing field") by modification of the tax benefits afforded under section 936, and reducing, as necessary, the cover over of U.S. taxes and customs duties to Puerto Rico. Thus, the costs of any increased benefits under the commonwealth option are entirely funded by the Puerto Rico Government and U.S. companies operating in Puerto Rico.

Uniformity clause

The Finance Committee believes that the statehood option must ultimately entail Federal tax treatment of Puerto Rico and its residents that is uniform with the Federal tax treatment of U.S. residents and the United States as a whole. As described above, however, the Finance Committee believes that the transition to tax treatment as a State should be reasonably gradual. Were the Finance Committee's desire for a gradual tax transition accompanied by immediate statehood, as provided under the bill as reported by the Energy and Natural Resources Committee, Federal taxes in Puerto Rico after statehood would temporarily differ from Federal taxes in the other States, and these differences would be subject to scrutiny under the tax uniformity clause of the U.S. Constitution.

During its hearings, the Finance Committee heard testimony suggesting that such a disparity in tax treatment would be inconsistent with the uniformity clause as the clause has been interpreted under existing case law. It was argued the temporary nature of such tax differences would not alter the conclusion. Other testimony argued that special tax treatment of Puerto Rico would not violate the uniformity clause. Moreover, the Chairman of the Senate Judiciary Committee has advised the Finance Committee that he believes there are serious questions about the constitutionality of the bill, under the uniformity clause, as reported by the Energy and Natural Resources Committee.[25]

It is likely that the issue as to whether or not the bill would violate the Constitution would not be resolved by the courts until after the referendum takes place. The Committee believes that an orderly transition would be undermined during the pendency of the dispute. The Committee would consider its purposes frustrated if a judicial disapproval following admission to statehood resulted, for example, in the immediate and retroactive termination of the gradual phase-in period. In addition, the Committee does not wish to place in doubt the consequences that Puerto Rican voters can anticipate should statehood be chosen.

The Finance Committee has not concluded that the tax differences in the transitional period would or would not be ruled unconstitutional by the courts were Puerto Rico to be a State during that period. However, the Committee believes that the constitutional concerns that have been raised are significant. Because the Committee believes that a gradual transition period is essential in order to integrate Puerto Rico into the United States without excessive economic dislocation and administrative disruption, and because the Committee believes that the best way reliably to provide for such a gradual period is to delay the incorporation of Puerto Rico into the United States until the transition measures are completed, the Committee believes it necessary to delay the date of actual admission of Puerto Rico as a State (and delay incorporating Puerto Rico into the United States for uniformity clause purposes) until the conclusion of any necessary period of transition, rather than delay the uniform application of Federal income taxation to Puerto Rico for any period after admission.

C. DESCRIPTION OF S. 712 AND EXPLANATION OF AMENDMENT

1. In General

The bill (S. 712), as reported by the Senate Committee on Energy and Natural Resources, provides for a referendum to be held on June 4, 1991 (and if necessary for a runoff referendum to be held on August 6, 1991), or on a date (or dates) during the summer of 1991 as may be mutually agreed by the three principal political parties of Puerto Rico. The purpose of the referendum will be to determine whether Puerto Rico is to become a U.S. State, become an independent country, or remain in a commonwealth relationship with the United States. The procedures for implementing

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[25] Letter from Joseph R. Biden, Jr., Chairman of the Committee on the Judiciary, to Lloyd Bentsen, Chairman of the Committee on Finance, November 13, 1989.

whichever status option receives a majority (as certified to the President and the Congress of the United States by the Governor of Puerto Rico) are detailed in title II (which applies if statehood is chosen), title III (independence), and title IV (commonwealth) of the bill.

The proposed Committee amendment ("the amendment") replaces those provisions of the bill that are within the jurisdiction of the Finance Committee. In addition, where a bill provision relates to matters both within and without the Finance Committee's jurisdiction, the amendment provides modifications with respect to matters within the Finance Committee's jurisdiction. This explanation describes those bill provisions that are modified but not deleted, and describes all provisions of the Finance Committee amendment.

The Committee expects that the Chairman of the Finance Committee will offer an amendment to the bill on the Senate floor to accommodate action by the Senate Committee on Agriculture, Nutrition, and Forestry with respect to the Food Stamps Program, to the extent consistent with the approach adopted by the Finance Committee.

2. Title II (Statehood)

Description of the Bill

Should statehood be certified as having obtained a majority of the votes cast in the referendum, the Commonwealth of Puerto Rico would be admitted as a State on an equal footing with the other States (bill sec. 201). Upon admission of Puerto Rico into the Union, all of the local laws then in force in Puerto Rico would continue in force and effect (except as modified or changed by the bill) subject to repeal or amendment by the Puerto Rican legislature (bill sec. 208(a)).

Explanation of Amendment

In general

Under the amendment, if statehood is certified as having obtained a majority of the votes cast in the referendum, the President is directed to issue a proclamation announcing the election results. Upon the issuance of the proclamation, the Commonwealth of Puerto Rico will be admitted as a State as of the first day of January of the fifth calendar year beginning after the certification of the referendum in favor of statehood. Thus, for example, if certification of the referendum in favor of statehood were to occur during 1991, Puerto Rico would become a State as of January 1, 1996.

Election of members of Congress

The amendment further provides that not later than the first day of the fourth calendar year following the calendar year in which the certification in favor of statehood occurs, the Governor of Puerto Rico will issue a proclamation for the elections of Puerto Rico's U.S. Senators and members of the House of Representatives. Such elections would occur either on the first Tuesday in November of the fourth calendar year following the calendar year in which the certification of the referendum occurs, or on such other

date during autumn of that year as may be mandated by legislation enacted by the Government of Puerto Rico. Under the amendment, the date on which the persons elected to represent Puerto Rico as U.S. Senators and members of the U.S. House of Representatives would be entitled to seats in Congress and to all the rights and privileges of Senators and Representatives of the other States in Congress will be on the date on which Puerto Rico's admission as a State becomes effective.

Application of U.S. tax laws to Puerto Rico

The amendment adds new section 214 to the bill, which section includes rules relating to the imposition of the U.S. internal revenue laws to Puerto Rico and to certain transfers of revenue between the governments of the United States and Puerto Rico. As a general rule, the provisions of the Internal Revenue Code would become fully applicable to the State of Puerto Rico and its residents in the same manner as those rules apply to all other States and the residents thereof as of the date on which Puerto Rico enters into statehood. In addition, subject to transition rules, provisions of the Internal Revenue Code that presently apply to Puerto Rico (as they may be amended from time to time) will continue to apply until the date that statehood takes effect.

Transition period for income taxes

In general

As a general rule, application to Puerto Rico of the Federal income tax laws would be phased in ratably over a four-year transition period. The transition period for income taxes commences with a taxpayer's second taxable year beginning after the certification of the referendum, and generally ends with the taxable year that includes the date of admission of Puerto Rico as a State. For example, if the certification of the referendum were to occur on October 15, 1991, the transition period with respect to a calendar year taxpayer would begin with 1993 and end with 1996. For a taxpayer with a taxable year that ends September 30, the transition period would commence with the taxpayer's taxable year beginning October 1, 1993, and would end with the taxable year beginning October 1, 1996. However, as discussed in more detail below, a taxpayer in the latter situation would be subject to special phase-in rules since a portion of its third taxable year during the transition period occurs after Puerto Rico becomes a State.

The Committee believes that this transition period is essential in order to integrate Puerto Rico into the United States without excessive economic dislocation and administrative disruption. The amendment provides for the transition period to take place prior to the admission of Puerto Rico as a State, rather than subsequent thereto, for the specific purpose of delaying the incorporation of Puerto Rico into the United States for uniformity clause purposes until the transition measures are completed.

During the transition period, the Federal income tax laws will be applied to all persons in the same manner as if Puerto Rico were a State and without regard to Code section 933. The difference, however, between actual U.S. tax liability for any year in the transi-

tion period, and what would have been U.S. tax liability for that year under current possession treatment (i.e., treatment of Puerto Rico as a possession of the United States and application of Code section 933), will be limited to the applicable phase-in percentage. That is, the phase-in percentage will only apply to the difference between two hypothetical tax liabilities: the liability that would exist if Puerto Rico were a State on equal tax law footing with the other States, and the liability that would exist if Puerto Rico and its residents remained subject to possession treatment as under present law. Generally, the applicable phase-in percentage is 25 percent in the first year of the transition period, 50 percent in the second year, 75 percent in the third year, and 100 percent in the fourth year (if any).

During the first year of the transition period Puerto Rico and its residents would be treated no differently than the United States and its residents to the extent of 25 percent of the difference between current law U.S. tax liability and hypothetical full U.S. tax liability. For example, assume a U.S. resident earning $100 of taxable income during a taxable year would pay $28 of U.S. tax. Under the amendment, a Puerto Rico resident with the same amount of taxable income earned in Puerto Rico, and no U.S. tax liability on that income under current law, would pay $7 of U.S. tax under the amendment. Generally, the percentage referred to above is increased to 50 percent for the second year of the transition period, to 75 percent for the third year of the transition period, and to 100 percent for the fourth year of the transition period and thereafter. Thus, assuming the facts provided in the preceding example applied to each year of the transition period, the Puerto Rico resident would pay $14 of U.S. tax in the second year of the transition period, $21 of U.S. tax in the third year, and the full amount of U.S. tax (i.e., $28) in the fourth year.

As another example, assume that during a taxable year in the transition period a taxpayer would have a hypothetical U.S. tax liability of $100 computed under present-law rules, and a hypothetical U.S. tax liability of $150 computed as if Puerto Rico were a State on an equal footing for tax purposes with the other States. Under the amendment, the actual tax liability would be $100 plus a percentage of $50 (the excess of $150 over $100). During the first year of the transition period, the taxpayer's actual liability under the amendment would be $112.50, or $12.50 (25 percent of $50) plus $100 (the amount of U.S. tax that the taxpayer would have been liable for notwithstanding the amendment).

As a third example, assume that for a taxable year in the transition period a taxpayer would have a hypothetical U.S. tax liability of $150 as computed under present-law rules, and a hypothetical U.S. tax liability of $100 computed as if Puerto Rico were a State on an equal footing for tax purposes with the other States. To determine the taxpayer's U.S. tax liability in this case, the taxpayer's tax liability computed under present-law rules of $150 would be reduced by the product of $50 multiplied by the applicable phase-in percentage for that year. Assuming the year in question is the taxpayer's second taxable year in the transition period, total U.S. tax liability for that year would be $125.

If under the Internal Revenue Code a taxpayer has a net operating loss for a taxable year during the transition period, the Committee intends that the full amount of the net operating loss would be available to be carried back or carried forward, as appropriate, based on present-law rules applicable to the utilization of net operating losses; that is, the amount of the net operating loss would not be reduced by the phase-in percentage applicable for the year of the transition period in which the loss was incurred. For example, if in the second taxable year of the transition period a Puerto Rico corporation incurred a net operating loss of $1,000 attributable to its operations in Puerto Rico, it is intended that the full amount of the loss could be carried forward to the third year of the transition period (or carried back to the first year of the transition period, if appropriate). If in the third year of the transition period the corporation had zero hypothetical U.S. tax liability computed under present-law rules, and generated pre-NOL taxable income of $5,000 from its operations in Puerto Rico, then its taxable income for the year would be $4,000 ($5,000 reduced by the $1,000 net operating loss carryforward). The taxpayer's resulting tax liability as computed under Code section 11 on taxable income of $4,000 would be subject to the applicable phase-in percentage for year three of the transition period (i.e., 75 percent).

Under the amendment's transition period for income tax, a special rule applies if the January 1 on which Puerto Rico is admitted to statehood falls within a taxpayer's third taxable year of the transition period. Under this special rule, the 75-percent limitation, which otherwise applies to the entire year-three difference between hypothetical U.S. tax liability computed under present-law rules and hypothetical U.S. tax liability computed as if Puerto Rico were a State treated for tax purposes like any other State, applies only to a pro-rata portion of that difference. The portion of the difference to which the limitation applies is based on the ratio which the number of months in the taxable year falling before statehood becomes effective bears to the total number of months in that taxable year. This special rule only affects taxpayers whose taxable years end between January 1 and the day of the year on which certification of the referendum results occurs.

As an illustration of the foregoing special rule, assume a fiscal year taxpayer has a taxable year ending June 30 and that the certification of the referendum in favor of statehood occurs on October 15, 1991. Thus, Puerto Rico would become a state as of January 1, 1996. The taxpayer's third taxable year of the transition period would be the taxable year beginning July 1, 1995 and ending June 30, 1996. One-half of the taxpayer's third taxable year of the transition period would fall prior to the effective date of statehood and the other half would fall after such date. Assume that the taxpayer has zero hypothetical U.S. tax liability computed under present-law rules, but has $100 of hypothetical U.S. tax liability computed as if Puerto Rico were a State. Under the amendment, one-half of the difference in these two amounts (one-half of $100, or $50) would be eligible for reduction at the regular year-three applicable percentage (i.e., 75 percent), to $37.50. The other $50 of that difference is not eligible for any reduction. Actual U.S. tax liability for the entire year is thus $87.50 (i.e., zero (present-law tax liability) plus

87.5 percent of the difference between present-law and full statehood tax liability).

Similar phase-in rules apply during the transition period to refundable tax credits, such as the earned income tax credit. For example, if under full application of U.S. law a Puerto Rican individual would qualify for a refund as a result of the earned income tax credit in the amount of $100 in each of the four years of the transition period, and in each of those years the taxpayer would have a hypothetical U.S. tax liability of zero computed under present law rules, then that individual would receive a $25 refund in year 1 of the transition period, a $50 refund in year 2, a $75 refund in year 3, and a full $100 refund in year 4.

Under the amendment, a taxpayer whose first taxable year begins after the date of certification of the referendum will be treated for purposes of administering the phase-in rules during the transition period as if the taxpayer had a taxable year in effect on the certification date and at all times thereafter. To illustrate, assume that the certification in favor of statehood occurs on October 15, 1991. Further assume that a taxpayer's first taxable year is the fiscal year ending June 30, 1995. For purposes of the application of the amendment's transition rules, the taxpayer is deemed to have been in existence during the fiscal years ending June 30, 1992, 1993, and 1994. As a result, the fiscal year ended June 30, 1994 will be deemed to be the taxpayer's first taxable year during the transition period, and its first actual taxable year (the fiscal year ended June 30, 1995) will be treated as its second taxable year of the transition period. Additionally for this purpose, the taxpayer's first actual taxable year will be deemed to include a full twelve months, even though in fact it may have been a short year.

Treatment of Puerto Rico as a State for tax purposes

The amendment provides that beginning in the first year of the transition period, Puerto Rico generally would be considered a State under the Internal Revenue Code for purposes of application of the phase-in rules for the U.S. income tax. Thus, for example, a corporation incorporated under the laws of Puerto Rico would be considered a U.S. corporation and would be subject to U.S. tax (at the appropriate phase-in level) on its worldwide income.

If, however, the stock of a Puerto Rico corporation were owned by a U.S. person or persons, the portion of the foreign source income of the corporation not subject to U.S. tax because of the phase-in rules would continue to be subject to the various anti-deferral statutes of the Code such as the rules applicable to subpart F income, passive foreign investment companies, personal holding companies, foreign personal holding companies, and the accumulated earnings tax.

Under the amendment, the phase-in of the U.S. income tax laws during the transition period to persons resident in Puerto Rico does not apply to foreign sales corporations (FSCs) created or organized under the laws of Puerto Rico. Thus, a Puerto Rican FSC will continue to be treated as a foreign corporation, and will continue to qualify for regular FSC treatment (such as full treatment of its exempt foreign trade income as foreign source non-effectively con-

nected income) until the date that Puerto Rico is admitted as a State.

Sourcing of income

Income earned from sources within Puerto Rico generally is considered U.S. source income for purposes of the U.S. tax liability being phased in (except where necessary to properly implement the phase-out of the possession tax credit as discussed below). This rule, for example, causes income earned from sources within Puerto Rico by non-U.S. residents generally to become subject to U.S. taxing jurisdiction (although the overall U.S. tax liability on such income would be limited by the phase-in rules).

Treatment of taxes paid to Puerto Rico

The Committee intends that taxes paid to Puerto Rico during the transition period are to be treated as taxes paid to a State for purposes of the U.S. tax liability being phased in. Thus, no foreign tax credit is allowed for such taxes in determining U.S. tax liability under the phase-in percentage. However, a deduction for the amount of such taxes generally is permitted for that purpose to the extent provided under Code section 164.

Transition period for section 936

The amendment provides a specific set of transition rules, covering the same transition period and using comparable phase-in percentages to the general income tax transition rules, applicable to the income tax credit against U.S. tax on Puerto Rico income provided under section 936. The transition to full Federal income taxation as described above precludes the use of section 936 credits by corporations created or organized under the laws of Puerto Rico for years beginning in or after the transition period. Corporations created or organized under U.S. laws (or those of the current States or the District of Columbia), however, are in some cases permitted to use section 936 income tax credits to the extent permitted under the limitations provided under the special section 936 transition rules.

Under this provision of the amendment, the section 936 credit generally is phased out ratably over a four-year period commencing in the section 936 corporation's second taxable year that begins after the certification of the referendum. That is, the amount of the section 936 credit available with respect to income or investments from activity in Puerto Rico is reduced to 75 percent of the amount of the credit that would be available absent the phase-out rules for a section 936 company's second taxable year beginning after such certification. The applicable percentage is 50 percent for the third taxable year, and generally is 25 percent for the fourth taxable year beginning after such date. Commencing with the fifth taxable year beginning after certification of the referendum, the section 936 credit no longer is available with respect to such income or investments.

As in the case of the general income tax transition rule, the amendment contains a special rule which applies if the January 1 on which Puerto Rico is admitted to statehood falls within a taxpayer's third taxable year of the transition period. Under this spe-

cial rule, a pro-rata portion of the section 936 credit otherwise available for that year is not available at all for operations in Puerto Rico. Thus, for a fiscal year taxpayer with a taxable year ending June 30, only 25 percent of one-half of the credit otherwise available (absent the phase-out) for the third year of the transition period would be available, assuming that year ended after statehood became effective. This special rule only affects taxpayers whose taxable years end between January 1 and the day of the year on which the referendum results are certified.

The Committee intends that section 936 credits be made available to a U.S. corporation under these rules during the transition period only if the taxpayer was previously operating under the credit and then only in an amount based on the taxpayer's prior utilization of the credit. Thus, during the transition period, the section 936 credit is available only to corporations that have elected under section 936 for the taxable year that includes the date of certification of the referendum. Moreover, the amount of section 936 credits allowable to a qualified corporation in any year during the transition period (before reduction by the applicable phase-out percentage) is limited to 130 percent of the average amount of section 936 credits taken by the taxpayer (or its predecessors) in the three most recent taxable years ending prior to August 1, 1990 (not taking into account years in which neither the taxpayer nor any predecessor was in existence).

If neither the corporation nor its predecessors (if any) had a taxable year ending before August 1, 1990, the limitation on the amount of credits that may be taken by the corporation in any year during the transition period (before reduction by the applicable phase-out percentage) is equal to the amount of section 936 credits taken by the corporation (or its predecessor, if any) for its first taxable year ending on or after August 1, 1990. The Committee intends that if such a corporation's first taxable year is a year consisting of less than twelve months, then the Secretary may permit the corporation (by regulations or otherwise) to annualize the amount of its first-year credits for purposes of determining its limitation.

Transition period for employment and excise taxes

A transition period for employment taxes covered under Chapter 24 of the Internal Revenue Code and for excise taxes imposed under the Code is provided under the amendment, during which Puerto Rico will be treated as a State for purposes of these taxes. In general, the transition period for these taxes commences with the second calendar year beginning after the certification of the referendum. Thus, for example, if the certification of the referendum in favor of statehood were to occur on October 15, 1991, the employment and excise tax transition period would commence with the 1993 calendar year. Under this example, beginning on the first day of 1993, U.S. excise taxes would be imposed in Puerto Rico in the same manner as they are within the United States (subject to certain transition rules).

During the transition period, the amount of employment and excise taxes that would be payable as a result of treating Puerto Rico as a State under the amendment will be phased in ratably

over a four-year period. The phase-in percentage is 25 percent in the first year of the transition period, 50 percent in the second year, and 75 percent in the third year. For the fourth year of the transition period and thereafter, full U.S. employment and excise tax will be collected.

The transition rules for excise taxes do not apply with respect to the excise taxes on employers that are currently applicable to Puerto Rico (i.e., the tax on old-age, survivors, and disability insurance (sec. 3111) and the Federal unemployment tax (sec. 3301)). Employers in Puerto Rico will continue to be required to pay these taxes at the full statutory level during the transition period.

A special rule applies with respect to the imposition of U.S. excise taxes on goods which are held for sale in Puerto Rico on the first day of the second, third, fourth, or fifth calendar year beginning after certification of the referendum, and which are held on any such date beyond the point at which tax otherwise would be imposed under the relevant provision of the Code. The amendment imposes a tax on such goods equal to the excess of the amount of tax that would be imposed on those goods under the applicable phase-in rate for the year in question over the amount of tax that would have been paid on those goods under the applicable phase-in rate (if any) for the immediately preceding year. Because the phase-in rates annually increase by 25 percent under the amendment, taxable goods held for sale on January 1 of any year during the transition period beyond the point at which the relevant tax generally would be imposed would be subject to tax equal to 25 percent of the full amount of tax otherwise prescribed for such goods under the Code. In such a case, the person holding the goods is liable for payment of the tax, which is due and payable on February 15 of the calendar year in which imposed in the same manner as the excise tax that would have been imposed under the Code during that year on similar goods.

As an illustration of the foregoing rule, assume that the certification of the referendum in favor of statehood occurs on October 15, 1991, so that the excise tax transition period would begin in 1993. If on January 1, 1993 a resident of Puerto Rico holds goods for sale that would be subject to U.S. excise tax during the transition period, but holds those goods beyond the point at which such tax generally would be imposed under the Code, then that person would be liable for the excise tax on those goods in 1993 at the year-one phase-in rate (i.e., 25 percent of full tax liability). The tax would be payable on February 15, 1993. If on January 1, 1994, the person held similar goods for sale, then the taxpayer would be liable for U.S. excise tax with respect to those goods on February 15, 1994. The amount of tax would be equal to the full amount of tax as prescribed under the Code on similar goods, multiplied by 25 percent (i.e., the difference between the year-two phase-in rate of 50 percent and the year-one phase-in rate of 25 percent).

Excise taxes on goods shipped from Puerto Rico to the United States

Under the amendment, the phase-in of tax pursuant to the transition period rules does not apply to goods shipped to the United States from Puerto Rico which are currently subject to U.S. excise

tax under section 7652(a) of the Code. These goods will be subject to full U.S. excise tax during the transition period. The amendment also terminates, effective at the beginning of the transition period, application to Puerto Rico of the special rules of section 5314 (exempting from U.S. tax Puerto Rico distilled spirits brought into the United States for certain nonbeverage purposes).

Excise taxes on goods shipped to Puerto Rico from the United States

The amendment also terminates application to Puerto Rico of the special rules of section 7653 of the Code pertaining to the excise taxation of goods shipped from the United States to Puerto Rico. This provision of the amendment is effective as of the beginning of the excise tax transition period. Thus, for example, goods manufactured in the United States and shipped to Puerto Rico after commencement of the transition period would not be eligible for the exemption from U.S. excise tax that is presently provided in section 7653(b) of the Code.

Estate and gift taxes

In the application of U.S. estate and gift taxes to persons resident in Puerto Rico, there is no transition period under the amendment. Thus, estate and gift taxes would be imposed with respect to decedents dying on or after, or for gifts made on or after, the first day of January of the fifth calendar year beginning after the certification of the referendum. If, for example, the certification of the referendum in favor of statehood occurs on October 15, 1991, the U.S. estate and gift taxes would first apply to residents of Puerto Rico with respect to decedents dying, or for gifts made, on or after January 1, 1996.

The amendment also provides rules intended to prevent avoidance of the U.S. estate and gift taxes through transfers made between the date of the filing of the amendment and the effective date of statehood. Under the anti-avoidance rules, all gifts made during this period are taken into account in determining the appropriate marginal rates and unified credit applicable to taxable transfers after the effective date of statehood. In addition, the gross estate of a decedent dying on or after the effective date of statehood would include any property transferred by the decedent during this period if the decedent or decedent's spouse, directly or indirectly, retains any degree of ownership or control of a beneficial interest (including a life estate) in the property as of the date of death, or disposes of or relinquishes such ownership or control within three years of death.

Cover over of taxes to Puerto Rico

The amendment provides that the cover over of excise taxes and customs duties by the United States Treasury to Puerto Rico mandated under present law will continue during years prior to Puerto Rico's admittance as a State. The amendment further provides that during the transition periods for imposition of the U.S. income, employment and excise taxes, any such taxes newly imposed as a result of the phase-in during the transition periods allocable to years (or portions thereof) preceding the date of Puerto Rico's ad-

mittance as a State will be covered over to Puerto Rico. Moreover, a portion of the revenues to the U.S. Treasury generated during the section 936 transition period from the phase out of section 936 will be covered over to Puerto Rico to the extent necessary to make the provisions of the bill related to statehood revenue neutral to the U.S. Treasury for that year.

Authority to develop other transitional rules

In addition to the special rules specified above, the amendment explicitly recognizes Congress' authority to enact any appropriate transitional rules that would be necessary to properly implement the phase-in of the U.S. tax system in Puerto Rico and the phase-out of the section 936 tax credit. The Committee understands that additional legislation to perfect the bill might be required for this purpose. Moreover, the amendment authorizes Treasury to promulgate such regulations as are necessary or appropriate to carry out the purposes of the transition provisions and to implement the transition to statehood.

Amendments to trade laws

Under the statehood option, Puerto Rico's special trade arrangements would be eliminated; that is, Puerto Rico would be treated like any other State. The amendment repeals the authority granted to the Legislature of Puerto Rico to impose a tariff on imported coffee (bill sec. 215(a)). Consistent with the bill's policy of providing a transition period prior to the effective date of statehood, the amendment requires the import duty on coffee to be phased out over four years beginning with the second year after certification of the referendum.

The amendment provides that the Legislature of Puerto Rico would be precluded from imposing any additional duties following the date of certification of the referendum. The amendment also makes a number of necessary conforming amendments to other statutes.

The amendment eliminates the special treatment provided to Puerto Rico under the CBERA (bill sec. 215(b)). Beginning on the effective date of statehood, neither the cost nor value of materials produced in Puerto Rico, nor the cost of processing operations performed in Puerto Rico, will be included for purposes of determining whether an imported article qualifies for duty-free treatment under the CBERA.

Spending program amendments under statehood

Transition period—in general

Under the amendment, there would be a five-year transition period for social welfare benefit programs, which entails the removal of the current caps on those programs as they apply to Puerto Rico and leads to full social welfare benefits in Puerto Rico commensurate with statehood status upon the admission of Puerto Rico as a State. In order to allow time for planning and development of the necessary administrative capacity, no changes in social welfare benefit programs would be made during the first calendar year following certification of the referendum results for statehood. In the

second year following certification, benefit enhancements would begin at levels which represent 25 percent of the full increase in benefits that will take place after the transition. In the third year following certification, 50 percent of the increased benefits will be implemented; in the fourth year, 75 percent. On January 1 of the fifth calendar year following the year of certification, the benefits commensurate with statehood status will be fully implemented as described below. During the transition period, the added Federal costs of enhancing the programs described below would be offset by limiting, as described above, the amount of increased Federal tax revenues collected during the transition period that are covered over to Puerto Rico. In addition, as discussed below, the amendment places a new cap on certain Federal spending programs during a period prior to Puerto Rico's admission into statehood.

Supplemental Security Income and Aid to the Aged, Blind, and Disabled

The Federally administered program of Supplemental Security Income (SSI) would be implemented in Puerto Rico starting on a partial basis in the second calendar year following certification of the referendum results for statehood. Thus, if statehood is chosen and the results are certified in 1991, the Federally administered SSI program would first be implemented, on a partial basis, in 1993. The rules of the SSI program would apply in Puerto Rico exactly as they apply in other States. The amendment would modify the general rules of the SSI program as applicable in all States to provide that benefit levels will be limited in such a way that the amount payable to an individual with no other income may not exceed 50 percent of the per capita income (based on the most rece t available data) in the State of residence. Benefits for a coupie would, as under present law, be 150 percent of the benefit for an individual. Under this rule, the monthly benefit rate in Puerto Rico would be approximately $215 at current benefit levels (i.e., ignoring the impact of future COLAs) and current per capita income levels. During the transition period, SSI benefit levels would be set at 25 percent of the full Statehood level in the second calendar year following certification of the referendum, 50 percent in the third such year, and 75 percent in the fourth such year.

In order to assure adequate lead time to prepare for proper administration of the program, the amendment would allow the Government of Puerto Rico to enter into an agreement with the Secretary of Health and Human Services to delay implementation of the SSI program to a date later than the beginning of second year after certification of the referendum—but not later than the date of admission to statehood. Under any such agreement, Puerto Rico would continue to operate the program of aid to the aged, blind, and disabled, but with benefits set at the levels that would have prevailed had the SSI program been implemented as described above.

Both during the transition period and after statehood takes effect, the program would be fully Federally funded (with Puerto Rico assuming the cost of any supplemental benefits it might elect to provide above the Federal levels). The present law cap on Federal funding would no longer apply.

Aid to Families with Dependent Children (AFDC)

As under present law, the level of benefits for the AFDC program would be set by the Government of Puerto Rico. The matching rate would be increased to the full medicaid match. At current per capita income levels, this would result in 83 percent Federal and 17-percent Puerto Rico matching. The present-law funding cap would be eliminated.

Medicaid

Once Puerto Rico becomes a State, the medicaid program would operate under the rules and requirements applicable to the regular medicaid program in other States. Matching under the statehood alternative would follow the regular medicaid rules which will result in an 83-percent Federal matching rate under existing per capita income levels.

During the transition period, under the amendment, the Government of Puerto Rico could continue to operate the current medicaid program with such modifications as might be appropriate to phase into the regular medicaid program upon full implementation. Federal matching starting in the second year following certification of the referendum would be at the 83-percent medicaid matching rate subject to a cap which would constrain new Federal costs to $79 million plus 25 percent of what would otherwise be payable under the regular medicaid matching provision. For the following two years, the percentage would be increased to 50 and 75 percent respectively.

Medicare

Under the amendment the Prospective Payment Assessment Commission would be directed to examine the current levels of reimbursement under the Hospital Insurance program and to advise the Secretary of Health and Human Services whether the current system appropriately reflects cost differentials between Puerto Rico and the States. The Secretary would be directed to propose appropriate legislative changes to the Congress if this study determines that the current system is not designed to achieve that objective. Pending such legislation, the current system would be kept in place.

Title XX social services program

Effective upon admission to statehood, Puerto Rico would be on the same footing as other States in the allocation of funds under the social services block grants program. This would not result in additional costs since this is a capped entitlement program with a fixed overall cost level. The net effect for Puerto Rico would be to approximately double its allocation. As with other States, the program would operate on a 100-percent Federal funding basis. This program would not be modified during the transition period.

Deficit neutrality

As explained above, choice of statehood by the people of Puerto Rico entails treatment of Puerto Rico as a State for purposes of application of the Federal internal revenue laws. Statehood further

entails removal of the application of the possession tax credit to operations located in Puerto Rico.

The amendment provides for increases in Federal spending for grants to Puerto Rico or to Puerto Rico residents under various Social Security Act programs. These programs currently are subject to caps that in the aggregate limit Federal spending under these programs to $161 million.

The amendment further provides that the excise taxes and customs duties which the U.S. Government is presently required to cover over to Puerto Rico will continue to be so covered over until Puerto Rico becomes a State. In addition, the amendment calls for all Federal revenues resulting from the imposition of Federal income, employment, and excise taxes to Puerto Rico and its residents during the respective transition periods allocable to years (or portions thereof) preceding the date of Puerto Rico's admittance as a State to be covered over to Puerto Rico. In order to assure deficit neutrality prior to statehood, the amendment provides that a portion of the Federal revenues attributable to the phaseout of the application of section 936 to Puerto Rico will also be covered over to Puerto Rico. Under the amendment, the amount to be so covered over is equal to the amount of such revenues that are allocable to a fiscal year (or portion of a fiscal year) prior to statehood which exceeds the sum of the increases in Federal spending programs (medicaid, SSI, and AFDC) and the amount of earned income tax credits claimed by Puerto Rican residents and refunded by the Federal Government that are allocable to that year (or portion of that year).

The Committee believes that anticipated Federal revenues from the phase-out of section 936 will be more than sufficient to pay for any expanded benefits under the statehood option, but to provide for the unlikely event that those revenues are not sufficient and to assure deficit neutrality, the amendment places a limitation on certain Federal spending programs during the period which includes any fiscal year ending after the end of the first calendar year beginning after the date of certification of the referendum and before the date of admission of Puerto Rico as a State. During this period, the United States will reduce the amounts otherwise payable to Puerto Rico under AFDC (and other programs under Title IV of the Social Security Act), aid to the aged, blind, and disabled, and medicaid to the extent that the sum of those amounts and any expenditures under the SSI program to residents of Puerto Rico exceeds the sum of $161,000,000 and any increase in Federal revenues as a result of the phase-out of the application of section 936 to Puerto Rico.

For purposes of computations under the above formula, the amounts of Federal revenues generated from the phase-out of section 936 are to be determined annually by the Secretary of the Treasury. The amounts so determined are to be appropriately adjusted for actual data in subsequent years.

3. Title III (Independence)

Description of the Bill

Should independence be certified as having obtained a majority of the votes cast in the referendum, Puerto Rico would convene a constitutional convention for the purpose of drafting a constitution for post-independence Puerto Rico (to be known as the "Republic of Puerto Rico") (bill sec. 301). Subsequent to the ratification of the resulting constitution by the people of Puerto Rico, and the election of such officers as may be provided for in such constitution, the President of the United States would by proclamation withdraw U.S. sovereignty over the territory and people of Puerto Rico, effective upon the issuance of a Proclamation of Independence by the Republic of Puerto Rico (bill sec. 307). Upon the issuance of this Proclamation of Independence, the Republic of Puerto Rico would become a sovereign country.

Upon the certification of the referendum results in favor of independence. Puerto Rico would no longer be treated as part of the United States for purposes of acquiring U.S. citizenship by place of birth under the Jones Act and the Immigration and Nationality Act (bill sec. 311(b)). In addition, an individual born outside the United States would not acquire U.S. citizenship at birth if the parents of that individual acquired U.S. citizenship solely by virtue of being born in Puerto Rico prior to the Proclamation of Independence pursuant to the provisions of the Jones Act and the Immigration and Nationality Act (bill sec. 311(c)).

Explanation of Amendment

General tax treatment

The amendment generally treats the Republic of Puerto Rico as a foreign country and not as a part of the United States for all tax purposes, effective upon Proclamation of Independence, except as specifically provided. The Committee intends that Puerto Rico geneally would be excluded from tax treatment in the Code that currently pertains specifically to Puerto Rico or other U.S. possessions. The Commttee anticipates that additional technical legislation will be required to fully carry out this general effect.

Phaseout of section 936

Under the amendment, the section 936 credit for income from Puerto Rico operations and investments is phase out over a four-year transition period. The transition period commences with the taxpayer's second taxable year that begins after the certification of the referendum results in favor of independence. For example, if a result for independence is certified during calendar year 1991, the amount of the tax credit allowed to a calendar-year taxpayer under section 936 would be reduced by 25 percent during 1993, by 50 percent during 1994, by 75 percent during 1995, and would be eliminated entirely beginning in 1996. Under the amendment, the section 936 credit, as so reduced, is available for these years in the transition period even if the Proclamation of Independence predates the end of the transition period.

The Committee intends that section 936 credits be made available to a U.S. corporation under these rules during the transition period only if the taxpayer was previously operating under the credit and then only in an amount based on the taxpayer's prior utilization of the credit. Therefore, during the transition period, section 936 credits are available only to corporations that are entitled to section 936 benefits for the taxable year that includes the date of certification of the referendum results. Moreover, the amount of allowable section 936 credits (before reduction by the applicable phaseout percentage) is limited to 130 percent of the average amount of section 936 credits taken by the taxpayer (or its predecessors) in the three most recent taxable years ending prior to August 1, 1990 (not taking into account years in which neither the taxpayer nor any predecessor was in existence). If neither the corporation nor its predecessors (if any) had a taxable year ending on or after August 1, 1990, the amount of allowable section 936 credits (before reduction by the applicable phaseout percentage) would be limited to the amount of section 936 credits taken by the corporation (or its predecessor, if any) for its first taxable year ending on or after August 1, 1990. The Committee intends that if such a corporation's first taxable year is a year consisting of less than twelve months, then the Secretary (by regulations or otherwise) may permit the corporation to annualize the amount of its first-year credits for purposes of determining its limitation.

The Committee recognizes that the creditability of Puerto Rico tax under the Code's foreign tax credit provisions may take on heightened importance after independence and the resulting termination of section 936 credits for Puerto Rico operations of U.S. corporations. U.S. corporations that continue operations in Puerto Rico after independence would be eligible for foreign tax credits for taxes paid to the Republic of Puerto Rico so long as those taxes qualify as creditable under the Code. The Committee understands that Puerto Rico taxes imposed in the past have, at least in some cases, been considered by the IRS to be creditable (see, e.g., Rev. Rul. 59-101, 1959-1 C.B. 189). The Committee takes no position on whether the taxes currently imposed by Puerto Rico, or taxes that Puerto Rico may impose in the future, are or are not creditable under applicable foreign tax credit rules. However, the Committee understands that such taxes as may be imposed by Puerto Rico in the future may well be designed to be eligible for U.S. foreign tax credits. The Committee wishes to emphasize that, in order for a foreign tax to be eligible for the foreign tax credit under section 901, the tax must satisfy the U.S. rules as they may be in effect, which rules are currently embodied in Code sections 901-907, regulations thereunder, and applicable rulings and judicial decisions. Under these rules, for example, the tax must not be refunded or otherwise used to provide a subsidy to the taxpayer or any related person, or any other party to the transaction or to a related transaction.

Treatment of certain U.S. citizens resident in Puerto Rico

Under the amendment, an individual who is a bona fide resident of the Republic of Puerto Rico after independence will continue to be eligible, under certain circumstances, for the exclusion currently provided under Code section 933 for income from sources within

Puerto Rico. The benefits of section 933 are available for a taxable year only for such a resident of the Republic of Puerto Rico who meets two tests. First, the individual must be a citizen of the United States solely by virtue of either being born in Puerto Rico pursuant to the provisions of the Jones Act and the Immigration and Nationality Act, or being born to parents who themselves are citizens of the United States solely by virtue of being born in Puerto Rico pursuant to the provisions of the Jones Act and the Immigration and Nationality Act, or both. Second, for that year the individual must have neither earned income in an amount exceeding the limitation on the foreign earned income exclusion applicable for that year, nor unearned income in an amount exceeding the sum of the applicable standard deduction and the applicable personal exemption or exemptions. A resident of Puerto Rico is ineligible for treatment under section 933 for any taxable year after the date of the Proclamation of Independence in which either test is not met. Moreover, in the case of an individual who would be so eligible for treatment under section 933, but whose spouse is ineligible, the former individual would be eligible only if the two spouses file separate income tax returns. Under the bill as reported by the Energy and Natural Resources Committee, individuals born in Puerto Rico after the date of the Proclamation of Independence generally are not U.S. citizens, and thus generally are not affected either by section 933 or by the Finance Committee amendment to section 933.

For estate and gift tax purposes, all U.S. citizens resident in the Republic of Puerto Rico are treated the same as U.S. citizens resident in any other foreign country.

The amendment also provides rules intended to prevent avoidance of the U.S. estate and gift taxes through transfers made between the date of the filing of the amendment and the effective date of independence. Under the anti-avoidance rules, all gifts made during this interim period are taken into account in determining the appropriate marginal rates and unified credit applicable to taxable transfers after the effective date of independence. In addition, the gross estate of a decedent dying on or after the effective date of independence would include any property transferred by the decedent during this period if the decedent or decedent's spouse, directly or indirectly, retains any degree of ownership or control of a beneficial interest (including a life estate) in the property as of the date of death, or disposes of or relinquishes such ownership or control within three years prior to death.

Application of U.S. excise taxation

Under the amendment, the cover over to the Treasury of Puerto Rico of excise taxes and customs duties collected by the United States on articles coming into the United States from Puerto Rico and on rum imported into the United States is phased out over five years (the first five calendar years beginning after the certification of the referendum results). For example, if the referendum results are certified in favor of independence during 1991, the amount of excise tax and customs duty covered over to Puerto Rico would be 80 percent of the amount otherwise due during 1992, 60 percent

during 1993, 40 percent during 1994, 20 percent during 1995, and none beginning in 1996.

Application of low-income housing credit

Generally the amendment terminates the low-income housing credit for years after the year in which the certification of referendum results occurs. The amendment does not affect the low-income housing credit for buildings, located in Puerto Rico, that receive a credit allocation from the State housing credit ceiling applicable to Puerto Rico prior to the end of the calendar year during which the referendum results are certified. Similarly the amendment does not affect the low-income housing credit for buildings, located in Puerto Rico, that would have received a credit allocation but for their use of qualified tax-exempt bond financing prior to the end of the calendar year during which the referendum results are certified. Because the amendment also leaves the credit rules in place, qualified buildings which have not yet been placed in service as of the end of the calendar year during which certification occurs may be placed in service and qualify for the credit within the two calendar years beginning after certification.

Notwithstanding any future extension of the low-income housing credit, no low-income credit dollar amount for buildings located in Puerto Rico, other than qualified carryover credits, is available for calendar years beginning after the date on which the referendum results are certified.

Treatment of tax-exempt bonds issued by Puerto Rico

The amendment provides that interest on originally tax-exempt bonds issued by Puerto Rico and its political subdivisions prior to the date of certification of the referendum results and outstanding on the date of certification of the referendum results remains tax-exempt in the same manner as if Puerto Rico were a State or a commonwealth.

In addition, the amendment permits Puerto Rico and its political subdivisions to continue to issue tax-exempt bonds (both governmental and qualified private activity) as provided under present law, through the last day of the fifth calendar year that begins after the date of certification of the referendum results. For example, if the referendum results are certified in favor of independence during calendar year 1991, Puerto Rico would be permitted to issue tax-exempt bonds through December 31, 1996.

International trade issues

As an independent country, Puerto Rico will no longer be part of the U.S. customs territory, and all special U.S. trade and tariff laws relating to Puerto Rico are specifically repealed by section 308(a)(2) of the bill. The amendment provides for future consideration of the trade relationship between the United States and an independent Puerto Rico (bill sec. 315). The amendment expresses the sense of the Congress that the United States should continue to maintain an open trade relationship with Puerto Rico both until and after independence, and that the President should encourage other countries to maintain open trading relationships with Puerto Rico and give favorable consideration to including Puerto Rico

under any preferential trade arrangements they maintain (bill sec. 315(a)). To assist in the consideration of the trading relationship between the United States and an independent Puerto Rico, the amendment requires that the Joint Transition Commission establish a Task Force on Trade to consider the manner in which trade between the United States and Puerto Rico will be governed after independence, and submit recommendations to the President and the Senate Finance and House Ways and Means Committees regarding the future trade relationship (bill sec. 315(b)).

The amendment modifies the Harmonized Tariff Schedule of the United States to provide unconditional most-favored-nation treatment for an independent Puerto Rico (bill sec. 315(c)). The amendment also provides authority for the President to designate an independent Puerto Rico as a beneficiary under the CBERA (bill sec. 315(d)). Finally, the amendment provides the President with specific authority to negotiate a free trade agreement with an independent Puerto Rico, and to have any implementing legislation for such an agreement considered through fast track legislative procedures during the five-year period after independence takes effect (bill sec. 315(e)-(h)).

Federal spending programs

General approach.—If Puerto Rico should choose independence in the referendum, social welfare programs within the jurisdiction of the Finance Committee would continue under existing terms and conditions through the end of the fiscal year in which independence is proclaimed and would cease thereafter. (The amendment does not modify the provisions of the Energy and Natural Resources Committee bill relating to transition grants to be made to Puerto Rico for a period of time after the termination of Federal programs.)

Unemployment compensation.—Amounts in the Puerto Rico "state" account in the unemployment trust fund would be transferred to the treasury of Puerto Rico and Puerto Rico would no longer be treated as a State for purposes of the Unemployment Program. U.S. companies operating in Puerto Rico would not be required to pay Federal unemployment (FUTA) taxes with respect to bona fide residents of Puerto Rico who are not U.S. citizens or who are U.S. citizens solely by reason of the Jones Act on the basis of birth in Puerto Rico and/or Puerto Rican parentage.

Social security.—By way of exception, the social security program of old age, survivors, and disability insurance, including the social security taxes applicable to that program, would continue in effect until the end of the fifth calendar year beginning after the date of certification, or until a time mutually agreed upon by the Puerto Rico and U.S. Governments. Individuals who had already applied for and met the eligibility requirements for benefits as of that date would continue to receive benefits under the terms and conditions applicable to all U.S. social security beneficiaries. Such individuals would also retain their eligibility for Medicare benefits when they are within the United States. The Governments of Puerto Rico and the United States would establish a Joint Task Force to seek to reach agreement on a coordination of the U.S. and Puerto Rico social security systems. The exact details of the agreement would

be worked out by the task force. The U.S. has similar agreements with several other countries under which each country pays a proportionate benefit under its program to individuals who have worked under both systems.

4. Title IV (Commonwealth)

Description of the Bill

The bill generally would amend the rules of both the House and the Senate to expedite review of certain recommendations of the Puerto Rican Government (where such recommendations are adopted by the Puerto Rican legislature and that fact is certified by the Governor to the Speaker of the U.S. House of Representatives and the President of the Senate) that particular Federal laws should not apply to Puerto Rico (bill sec. 403 (a) and (b)).

These provisions would not apply, however, to any Federal statutory law (1) establishing grants or services to individual U.S. citizens, (2) relating to citizenship, or (3) pertaining to foreign relations, defense, or national security (bill sec. 403(c)).

The bill also sets forth a mechanism under which the Governor of Puerto Rico could require agency review and judicial review of Federal regulations which apply to Puerto Rico but which the Governor determines are inconsistent with the policy, set forth in the bill, of enhancing the Commonwealth relationship to enable the people of Puerto Rico to accelerate their economic and social development, to attain maximum cultural autonomy, and in matters of government to take into account local conditions in Puerto Rico (bill secs. 402(b) and 404).

The bill provides that the Governor of Puerto Rico may enter into international agreements to promote the international interests of Puerto Rico as authorized by the President of the United States and consistent with the laws and international obligations of the United States (bill sec. 403(d)).

The bill also provides that Federal agencies may consolidate grants made to Puerto Rico under the same consolidation provisions applicable to the Virgin Islands and other U.S. possessions (bill sec. 407).

Explanation of Amendment

In general

The amendment provides that the provisions regarding expedited Congressional review (bill sec. 403 (a) and (b)) and the provision regarding Puerto Rican international agreements (bill sec. 403(d)), would not apply to any Federal law or provision thereof relating to matters within the jurisdiction of the Senate Finance Committee. The Committee intends that the process of negotiation and entry into international agreements relating to such matters (e.g., tax treaties) would be unaffected by the bill as amended by the Finance Committee. Under the amendment, the bill provisions regarding regulatory review (bill sec. 404) would not apply to any agency action relating to matters that would be within the jurisdiction of the Senate Finance Committee (as those matters are defined under the Senate Rules as of the date of enactment of the bill) if

they were the subject of legislation. Under the amendment the bill provision permitting grant consolidation (bill sec. 407) would not apply to grants to Puerto Rico with respect to programs established or operated under the Social Security Act.

Tax-related provisions and cover overs

The amendment changes the requirement that, in order to qualify for the section 936 credit, a domestic corporation must derive at least 75 percent of its gross income from the active conduct of a trade or business within a U.S. possession over a three-year period (Code sec. 936(a)(2)(B)). Effective for a corporation's fourth taxable year beginning after certification of the referendum in favor of commonwealth, the applicable percentage under the amendment is 80 percent. Effective for subsequent taxable years, the applicable percentage under the amendment is 85 percent. In the case of a taxpayer whose first taxable year begins after the certification date, the foregoing rules apply as if the taxpayer also had a taxable year, ending in the same month, in effect on (and after) the certification date.

The amendment also provides that cover overs from the United States to Puerto Rico of excise taxes collected by the United States on articles coming into the United States from Puerto Rico, and on rum imported into the United States, as provided under current law, and cover overs from the United States to Puerto Rico of customs duties, would be phased down over a period beginning after certification of the referendum. As described below, the amount of the reduction is tied to the increases in social spending programs covered by the amendment, less amounts related to projected increases in Federal tax revenues due to the change in the active business requirement in section 936 as described above. In addition, the amendment provides that any reduction in cover over must be no less than a fixed dollar amount (or fixed dollar amount as modified by a formula). These rules are described below, following the description of the changes in Federal spending programs under the amendment.

International trade issues

Under the commonwealth option, the amendment generally maintains present law with respect to Puerto Rico's special trade arrangements relating to coffee and treatment under the Caribbean Basin Initiative. The amendment modifies cover overs of customs duties, however, as described below.

Spending program amendments under commonwealth alternative

In general

Under the amendment, there would be enhancements to certain social welfare benefit programs, phased in over a transition period leading to full implementation generally as of the beginning of the fifth calendar year following certification of the results of the referendum for commonwealth. The amendment generally would require increased benefit levels under programs for the aged, blind, and disabled, and would increase the available Federal grants to Puerto Rico under those programs and the medicaid and aid to

families with dependent children (AFDC) programs. As described below, these changes tend to increase the parity between the benefits available under commonwealth and the benefits that would be available under statehood both during the transition period and upon full implementation. The financing of these benefits, however, would be differently shared under commonwealth than under statehood, in recognition of the different fiscal relationship between the Federal Government and the Government and residents of Puerto Rico under the two status options. Under commonwealth, the financing of the social welfare programs will generally be on a 50 percent Federal and 50 percent commonwealth basis.

Finally, the amendment replaces the present law fixed statutory cap on Federal funding of Social Security Act programs with a new structure which allows for growth in that funding subject only to a requirement relating to deficit neutrality concerns. This new mechanism provides for a new cap on Federal grants to Puerto Rico, which is related to the changes described above in the tax credits available under section 936 of the Internal Revenue Code, and to changes in the cover over of Federal excise tax and customs duty collections. The Committee expects, based on cost estimates available to it, that the statutory cap will not be reached, and that the revenues from the section 936 modification and the reduction in cover overs will be adequate to provide for the increased Federal social spending.

Transition period

In order to allow time for planning and development, no changes would be made in social welfare benefit programs during the first year following certification of the referendum results for commonwealth. In the second year following certification, changes would begin at levels that generally represent 25 percent of the full change that would take place after the transition. In the third year following certification, generally 50 percent of the full change will be implemented; in the fourth year, generally 75 percent. By the fifth calendar year following the year of certification, the changes will generally be fully implemented as described below.

Aid to the aged, blind, and disabled

The existing program of aid to the aged, blind, and disabled is retained but minimum benefit levels are established starting in the second calendar year beginning after certification of the referendum results for statehood. Thus, if commonwealth is retained and the results are certified in 1991, mandatory minimum benefit levels would first take effect in 1993. These minimum benefit levels would be the same as the benefit levels applicable under the SSI program as it would apply under the statehood option described in Part II above. As under statehood, benefit levels under commonwealth would assure that the basic benefit for an individual does not exceed 50 percent of per capita income. During the transition period, benefit levels would be set at 25 percent of the fully phased in level in the second calendar year following certification of the referendum results, 50 percent in the third such year, and 75 percent in the fourth such year. The costs of this program would be shared on a 50 percent Federal, 50 percent commonwealth basis

starting in the second calendar year following certification of the referendum results. The present-law dollar cap on Federal funding would no longer apply. However, the overall limitation explained below under the heading "Deficit neutrality" would apply.

Aid to families with dependent children

As under present law, the level of benefits for the AFDC program would continue to be set by the Government of Puerto Rico under commonwealth status (as would also be the case under statehood). Beginning on January 1 of the second calendar year beginning after certification of the referendum for commonwealth, the matching rate would be set at 50 percent Federal and 50 percent commonwealth. Also beginning on that date, the present-law dollar cap on Federal funding would no longer apply. However, the overall limitation explained below under the heading "Deficit neutrality" would apply.

Medicaid

Under the commonwealth alternative, the present $79 million cap on Federal funding for the medicaid program would be eliminated as of the fourth fiscal year beginning after the end of the calendar year in which the referendum results are certified. Federal matching would be provided on a 50 percent Federal, 50 percent commonwealth basis. During the transition period, funding would be capped at $79 million plus a percentage of the full Federal funding that would be available under an open-ended 50 percent matching rate. That percentage would be 25 percent in the first fiscal year beginning after the end of the calendar year in which the referendum results are certified, 50 percent in the following fiscal year, and 75 percent in the following fiscal year.

The Committee anticipates that the Commonwealth would continue to operate a medicaid program generally along the model of the medicaid system currently in operation in that jurisdiction. However, the additional funding would allow Puerto Rico to provide services through that system that are comparable to what would otherwise be available under the statehood option. The deficit neutrality provisions described below would include funding for the medicaid program.

Medicare

The Prospective Payment Assessment Commission would be directed to examine the current levels of reimbursement under the Hospital Insurance program and to advise the Secretary of Health and Human Services whether the current system appropriately reflects cost differentials between Puerto Rico and the States. The Secretary would be directed to propose appropriate legislative changes to the Congress if this study determines that the current system is not designed to achieve that objective. Pending such legislation, the current system would be kept in place.

Title XX

Effective in the fifth fiscal year beginning after the date of certification of the referendum results, the Commonwealth would be treated as a State for purposes of determining the amount of its

allocation of funds under title XX of the Social Security Act. However, the Commonwealth would be responsible for meeting 50 percent of the cost of this allocation. Since this change is not expected to increase the Federal cost of the program, the deficit neutrality calculations would not include this program.

Deficit neutrality

As explained above, choice of commonwealth by the people of Puerto Rico entails increases in Federal spending for grants to Puerto Rico under various Social Security Act programs. These programs currently are subject to caps that in the aggregate limit Federal spending under these programs to $161 million. The amendment would also increase Federal revenues by a modification of section 936 of the Code which is also described above.

Finally, the provisions of present law that require the United States Treasury to cover into the Puerto Rican treasury certain excise tax and customs duties receipts would be modified to reduce those cover overs. To the extent that excise tax and customs duty receipts permit, the amount of the reduction in the cover over must at least equal the excess of (1) Federal payments to Puerto Rico under the AFDC, foster care and adoption assistance, non-SSI aid to aged, blind, and disabled, and medicaid programs over (2) $161 million plus an additional dollar amount. As stated above, the additional dollar amount relates to the Federal revenue gains that may result from the amendment to the active business requirement under Code section 936.

For purposes of computations under the above formula, the amounts of the Federal payments to Puerto Rico under the programs listed above are to be determined on the basis of preliminary estimates of the Secretary of the Treasury in consultation with the Secretary of Health and Human Services during the fiscal year in question. These preliminary estimates are to be appropriately adjusted for actual data prior to the end of the subsequent fiscal year. The additional dollar amount to be added to the $161 million figure is zero for the first two fiscal years beginning in a calendar year beginning after the date of certification of the referendum results, $30 million for the third such fiscal year, and $80 million for the fourth such fiscal year. For fiscal years thereafter, the additional dollar amount is $101 million times the applicable ratio. The applicable ratio for any fiscal year is the ratio of gross national product for the last calendar year ending before the beginning of that year to the gross national product for the second calendar year beginning after certification of the referendum results.

Notwithstanding the foregoing rules, in every fiscal year the amount of the reduction in the cover overs (to the extent that excise tax and customs duty receipts permit) must be no less than the projected growth in Federal benefit costs less the section 936-related additional dollar amount. These minimum reduction amounts will be determined on the basis of a formula specified in the bill.

The Committee fully expects that the sum of the amounts associated with the section 936 modification and the excise tax and customs duty receipts subject to reduced cover over will be sufficient to finance the full increase in the Federal matching share of the

affected social welfare programs, assuming a 50 percent Federal matching share with no dollar ceiling. However, as a backup measure to assure that the bill maintains deficit neutrality, a provision has been included that places an overall limit on Federal funding of the AFDC, foster care and adoption assistance, aid to aged, blind, and disabled, and medicaid programs. This limit is equal to the present Federal funding level ($161 million), plus the additional dollar amount described above, plus the excise tax and customs duty receipts that would be subject to cover over under present law. While the Committee does not expect this limit to be reached either in the next few years or thereafter, the Committee would be prepared to reexamine the issue of appropriate financing for these programs if that should occur.

III. Budget Effects of Committee Amendment

In compliance with paragraph 11(a) of rule XXVI of the Standing Rules of the Senate, the following statement is made relative to the estimated budget effects of S. 712 as amended and reported by the Committee on Finance.

The estimated budget effects of S. 712, as amended, for fiscal years 1992–1995 is provided in the statement of the Congressional Budget Office (CBO). The CBO statement, included in Part IV.B. of this report, includes estimates of the revenue and outlay effects under statehood, independence, and commonwealth options provided under the bill as amended. The estimated revenue effects in the CBO statement are provided by the Joint Committee on Taxation.

IV. Regulatory Impact and Other Matters To Be Discussed Under Senate Rules

A. REGULATORY IMPACT

Pursuant to paragraph 11(b) of rule XXVI of the Standing Rules of the Senate, the Committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the bill (S. 712) as amended and reported by the Committee on Finance.

Impact on individuals and businesses, personal privacy, and paperwork

The purpose of S. 712 is to provide for the exercise of self-determination by the people of Puerto Rico through a referendum (to be held on June 4, 1991) on the future political status of the island. Title I sets forth the legal framework and timing of the referendum. Titles II, III, and IV set forth detailed definitions of the three respective status options; statehood (title II), independence (title III), and commonwealth (title IV). The option which receives a majority vote in the referendum would be implemented in accordance with the appropriate title of S. 712 as amended by the Committee on Finance. Thus, U.S. laws now affecting Puerto Rico would be amended under the bill as reported by the Committee on Finance, depending upon the option chosen in the referendum. The laws that would be amended by the bill include those within the jurisdiction

of the Committee on Finance (i.e., tax, trade, and social security laws).

The Committee on Finance amendments to titles II, III, and IV of the bill provide for a phase-in of the effects of applicable U.S. tax, trade, and social security laws on individuals and businesses in Puerto Rico under the three referendum options. (See Part II.C. of this report.)

B. OTHER MATTERS

Vote of the Committee

In compliance with paragraph 7(c) of rule XXVI of the Standing Rules of the Senate, the following statement is made relative to the vote of the Committee on Finance on the motion to report the bill. The bill (S. 712), as amended, was ordered reported by voice vote. The Committee on Finance makes no recommendation on whether the bill as amended do pass.

Consultation with Congressional Budget Office

In accordance with Section 403 of the Budget Act, the Committee on Finance advises that the Congressional Budget Office submitted the following statement:

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, September 14, 1990.

Hon. LLOYD BENTSEN,
Chairman, Committee on Finance,
U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the attached cost estimate of S. 712, the Puerto Rico Status Referendum Act, as ordered reported by the Committee on Finance on August 1, 1990. Because legislative language has been unavailable, the estimates are based on descriptions of the bill provided by the Senate Finance Committee staff. Therefore, these estimates are subject to change.

If you wish further details on this estimate, we will be pleased to provide them.

Sincerely,

ROBERT F. HALE
(For Robert D. Reischauer, Director).

Attachment.

CONGRESSIONAL BUDGET OFFICE COST ESTIMATE

1. Bill number: S. 712.
2. Bill title: The Puerto Rico Status Referendum Act.
3. Bill status: As ordered reported by the Senate Committee on Finance on August 1, 1990.
4. Bill purpose: To establish guidelines and provide resources for an island-wide referendum during the summer of 1991 in Puerto Rico. The referendum would allow Puerto Ricans to choose among statehood, independence, and enhanced commonwealth status. In addition, the bill specifies permanent changes and transition provisions for entitlement, trade, and tax issues for each of the options.

5. Estimated cost to the Federal Government: The estimated federal budget effects would be very different depending upon which status option—statehood, independence, or enhanced commonwealth—is chosen. The table below shows the estimated federal budget changes under each alternative. Because legislative language has been unavailable, the estimates are based on descriptions of the bill provided by the Senate Finance Committee staff. Therefore, these estimates may be changed after the legislative language is available.

The Committee on Energy and Natural Resources reported S. 712 in a form that would have altered programs under the jurisdiction of two other Senate Committees. Accordingly, the bill was rereferred concurrently to the Committee on Finance and the Committee on Agriculture, Nutrition, and Forestry so that those committees might make adjustments to laws within their respective jurisdictions. This estimate combines the costs of S. 712 as ordered reported by the Senate Energy and Natural Resources Committee, except for Food Stamp program costs, with the cost of the bill as ordered reported by the Senate Finance Committee. Food stamp costs are not included here because the Energy and Natural Resources Committee provisions for that program are not consistent with the deficit neutrality criterion in the Finance Committee bill.

ESTIMATED BUDGET EFFECTS UNDER ALTERNATIVE STATUS OPTIONS

[By fiscal year, in millions of dollars]

	1991	1992	1993	1994	1995
STATEHOOD					
Direct spending:					
Entitlement Programs—Finance:					
Budget authority		0	405	985	1,520
Estimated outlays		0	405	985	1,520
Other programs—Food Stamps:					
Budget authority		(1)	(1)	(1)	(1)
Estimated outlays		(1)	(1)	(1)	(1)
Tax sharing ("cover-over") payments to Puerto Rico:					
Estimated outlays [2]		0	465	1,275	1,841
Total direct spending:					
Budget authority		0	870	2,260	3,361
Estimated outlays		0	870	2,260	3,361
Total revenues		0	870	2,260	3,361
Total revenue and direct spending		0	0	0	0
Amounts subject to appropriation action:					
Estimated authorization level	5	(3)	(3)	(3)	(3)
Estimated outlays	5	(3)	(3)	(3)	(3)
Net impact on the deficit	5	(3)	(3)	(3)	(3)
INDEPENDENCE					
Direct spending:					
Federal benefit programs:					
Budget authority	0	0	0	750	−460
Estimated outlays	0	0	0	750	−460
Excise tax sharing ("cover-over") payments:					
Estimated outlays		−54	−109	−163	−218
Total Direct Spending					
Budget authority	0	−54	−109	587	−678
Estimated outlays	0	−54	−109	587	−678
Total revenues		3	458	989	1,670
Total Revenue and Direct Spending	0	−57	−567	−402	−2,348

ESTIMATED BUDGET EFFECTS UNDER ALTERNATIVE STATUS OPTIONS—Continued

[By fiscal year, in millions of dollars]

	1991	1992	1993	1994	1995
Amounts subject to appropriation action:					
Estimated authorization level	5	(3)	(3)	(3)	(3)
Estimated outlays	5	(3)	(3)	(3)	(3)
Net impact on the deficit	5	−57	−567	−402	−2,348
ENHANCED COMMONWEALTH STATUS					
Direct spending:					
Federal benefit programs:					
Budget authority		0	120	250	355
Estimated outlays		0	120	250	355
Tax sharing ("cover-over") payments for excise taxes and customs duties:					
Estimated outlays [2]		0	−120	−250	−325
Total Direct Spending:					
Budget authority		0	0	0	30
Estimated outlays		0	0	0	30
Total revenues		0	0	0	30
Total revenue and direct spending		0	0	0	0
Amounts subject to appropriation action:					
Estimated authorization level	5	(3)	(3)	(3)	(3)
Estimated outlays	5	(3)	(3)	(3)	(3)
Net impact on the deficit	5	(3)	(3)	(3)	(3)

[1] CBO prepared a cost estimate of the Food Stamp program as described in S. 712 as ordered reported by the Committee on Energy and Natural Resources. The estimates were increased food stamp outlays of $.7 billion annually beginning in 1992. An estimate of the Food Stamp program is not included in this estimate because the food stamp changes included in the Energy and Natural Resources reported bill are inconsistent with the deficit neutral criterion discussed in footnote 2.

[2] Under the commonwealth and statehood options, provisions of S. 712 as amended by the Senate Finance Committee are explicitly structured to be deficit neutral through 1995. The bill specifies that certain current law payments to the Puerto Rican Treasury be reduced to offset any increased costs to the federal government due to changes in entitlement programs under the jurisdiction of the Senate Finance Committee. These payments are known as "cover-over" payments and are classified as federal outlays. In essence, they transfer to Puerto Rico excise tax and customs duty amounts collected on products produced in Puerto Rico. The bill would also create a new tax sharing "cover-over" payment to return to Puerto Rico certain tax receipts in excess of certain outlays (statehood option).

[3] Less than $5 million.

Basis of estimate: Based on a report by the Bureau of Census—Federal Expenditures by State for Fiscal Year 1989—, federal expenditures in Puerto Rico were $6.7 billion in 1989. This amount has been growing approximately 6 percent to 7 percent a year. Assuming a continuation of these growth rates, we estimate federal expenditures in Puerto Rico of $9.8 billion in 1995. Spending estimates of this bill are incremental estimates to this base amount.

For purposes of the estimate, CBO has assumed that the referendum would occur and the results would be certified in the summer of 1991. Further, the estimates assume that procedures for implementing the certified status option would go into effect in fiscal year 1992. The bill has three status options that are discussed below.

The cost of the referendum would be independent of the option chosen. Although the bill does not provide a specific authorization, CBO estimates the cost of the referendum would be between $2.5 million and $4 million in fiscal year 1991. The cost of the referendum is included in the costs of each status option.

S. 712 would require the Attorney General to provide for adequate monitoring of the referendum by U.S. Marshals. Based on information from the Department of Justice, CBO estimates that these monitoring activities would cost between one-half million and two million dollars in 1991, depending on how the Marshals Service implements this provision.

If the Marshals service provides a minimal presence of on-call deputy marshals able to respond to disruptions at polling places, then costs would be toward the lower end of the range. If on the other hand, it creates a greater presence by providing more marshals to travel to and monitor all 1,602 polling places during the election, then costs would be closer to the higher end of the range. For purposes of this estimate, we assumed that the primary function of the U.S. Marshals would be to insure law and order at polling places and not to insure against election fraud. We therefore did not estimate the costs that would be incurred to provide oversight and security of ballot and machines.

S. 712 also would require the President to appoint a Referendum Information officer to distribute education information on the referendum. The bill authorizes the appropriation of funds to cover the expenses of the Information Officer. CBO assumed that the Information Officer would be appointed by November 1990 and would work through August of 1991. The estimate covers costs for salaries, overhead, printing, and postage. CBO estimates the cost of these activities would be $2 million in fiscal year 1991.

S. 712 results in interdependent revenue and outlay effects, mainly because of the deficit-neutral criterion discussed in footnote b., page 3, of this estimate. The Joint Committee on Taxation has provided the estimates of the income and excise tax provisions of S. 712 for all three options. Using these, CBO has computed adjustments to specific outlay and revenue line items to maintain the deficit neutrality totals for the bill.

Statehood: Under the Finance Committee version of S. 712, if statehood is chosen in the referendum, Puerto Rico would become a state January 1, 1996. In addition, the bill provides a transition period for some entitlement programs beginning January 1993. These programs would be phased in at 25 percent of full implementation costs in 1993, 50 percent in 1994, 75 percent in 1995 and 100 percent in 1996. Also, during the transition period, the bill would require the U.S. Treasury to pay to the Puerto Rican Treasury all federal collections from newly-imposed income and excise taxes, except to the extent needed to meet the additional federal costs of expanding certain entitlement programs. Finally, the bill would increase federal revenues because it repeals the possessions tax credit—Section 936 of the Internal Revenue Code—and because Puerto Rican residents would become subject to U.S. income and excise taxes if Puerto Rico were a state. The "cover-over" payments transferring U.S. income and excise tax receipts to Puerto Rico would be increased or decreased accordingly by the U.S. Treasury to assure that the Finance Committee Amendment would be deficit neutral during the transition period.

Entitlement programs: While Puerto Rico now is considered a state for many federal programs, it is not always treated identically to the rest of the 50 states. For example, federal funds available for AFDC, Foster Care, Aid to the Aged, Blind and Disabled (AABD) and Medicaid are capped in Puerto Rico. Currently, the SSI program is not available in Puerto Rico, but the AABD program is. Also, because Puerto Ricans do not pay income taxes, the Earned Income Tax Credit (EITC), the refundable portion of which is classified as a federal outlay, is not available in Puerto Rico.

This bill would provide the means for Puerto Rico to be treated identically to other states for the following programs: Medicaid, Medicare, SSI, AFDC, Foster Care and the EITC. Some of the programs like Medicaid and SSI would be phased-in over the 1993–1996 period, while others would be fully effective in 1993. The largest increase in federal costs would occur in the Medicaid and SSI programs.

The estimates for the entitlement programs are complex and uncertain in a number of respects. The uncertainties include the benefit levels for each program, the number of participants in each program, the actual amount of time the transition to statehood would take, and the comparability of the program and population in Puerto Rico to the U.S. Recent detailed data-bases that display the characteristics of current program participants and that permit estimates of potential participants are not available for Puerto Rico. This lack of data complicates the estimating process and increases the uncertainty of the estimates. Finally, some of the federal programs, in particular AFDC, are sensitive to the condition of the economy, particularly the unemployment rate. If the Puerto Rican economy should change under statehood, the costs to the federal government for these programs could change significantly. For example, participation in the AFDC and unemployment insurance programs would be higher, if unemployment increased significantly.

Medicaid.—Currently, Puerto Rico operates a limited Medicaid program. The federal government reimburses Puerto Rico for 50 percent of its Medicaid expenditures up to a federal cap of $79 million per year. S. 712 would raise the federal matching rate to 83 percent and by 1996 would eliminate the cap on federal funding. Based on conversations with island Medicaid staff, the Health Care Financing Administration (HCFA) regional office, and previous published work on Puerto Rico's public health care system, CBO has assumed that Puerto Rico would cover approximately 1.35 million participants annually under the more generous federal reimbursement rules. This estimate also assumes that Puerto Rico would increase the supply of services offered under Medicaid by 1996. The changes would be fully implemented as of January 1, 1996. Partial implementation of the program would begin on January 1, 1993 with the increase in federal costs set at 25 percent of the added costs of a fully implemented program. The increase would be set at 50 percent in 1994 and 75 percent in 1995.

We estimate that as a result of these changes Puerto Rico would receive from the federal government an additional $200 million in 1993 growing to $1.3 billion in 1996 (See table on page 9).

Medicare.—Under current law, Medicare reimbursements to hospitals in Puerto Rico are determined according to provisions applicable only to such institutions located there. In general, the current level of hospital reimbursement is based on a blend of Puerto Rico's discharge-weighted average costs per case (75 percent) and the U.S. national average costs per case (25 percent). These reimbursements are otherwise similar to those received by U.S. hospitals under the prospective payment system. The per-case payments to particular hospitals are adjusted for case mix, for local wages relative to Puerto Rican wages, and for geographic location (large

urban, other urban, and rural) in the same manner as in the U.S. Payments are also updated annually in a fashion similar to provisions applicable to U.S. hospitals.

Under the Senate Finance Committee's amendments, the Medicare program would continue as under current law until the Prospective Payment Assessment Commission has completed a report required by the bill. The Commission would be directed to examine the current levels of reimbursement under the Hospital Insurance program and to advise the Secretary of Health and Human Services whether the current system appropriately reflects the cost differential between Puerto Rico and the U.S. Therefore, CBO does not estimate a change in current federal Medicare spending in Puerto Rico because we cannot predict what changes, if any, would be recommended by the Commission.

SSI.—The Supplemental Security Income (SSI) program is not currently in effect in Puerto Rico. Federal expenditures for the island's program of Aid to the Aged, Blind, or Disabled (AABD) amount to about $16 million per year. Under the statehood option, the bill would modify the SSI program as it applies in all states such that the maximum benefit may not exceed 50 percent of the state's per capita income, based on the most recent available income data. The SSI program would be fully implemented in Puerto Rico under this provision as of January 1, 1996. Partial implementation of the program would begin on January 1, 1996. Partial implementation of the program would begin on January 1, 1993 with the increase in benefits set at 25 percent of that which would be provided under full implementation. The increase would be set at 50 percent in 1994 and 75 percent in 1995.

The estimated increase in federal expenditures from replacing the existing AABD program with SSI would be $160 million in fiscal year 1993, $290 million in fiscal year 1994, $400 million in fiscal year 1995, and $610 million in fiscal year 1996 (See table on page 9). The estimated cost for fiscal year 1993 is for the nine months beginning January 1, 1993. The estimate includes administrative expenses of $85 million in fiscal year 1993, $30 million in both 1994 and 1995, and $40 million in 1996. Administrative expenses will be relatively high in the first year of the program due to the cost of processing initial claims. The estimates assume participation of 104,000 aged and 247,000 blind or disabled persons in 1993, increasing to 107,000 aged and 262,000 blind or disabled persons in 1995.

The estimate of the number of aged persons participating in the program is based on data from the 1980 census. In a 1987 report on extending taxes and benefits to the U.S. territories, the General Accounting Office (GAO) used these data to estimate the number of aged persons who would be eligible for SSI. Participation of eligible persons is based on recent estimates of participation in the United States—55 percent. Because disabled persons are difficult to identify on the Census data, GAO estimated only the number of eligible aged persons. To estimate the number of disabled participants, we assumed that the ratio of disabled recipients to aged recipients would be the same in Puerto Rico as in the rest of the United States. The estimated number of Puerto Rican SSI participants from the 1980 Census data was then adjusted by the actual growth

rate in the U.S. SSI aged and disabled caseloads between 1979 and 1989. The estimated number of participants was then adjusted by CBO's baseline growth for the aged and disabled from 1990 through 1996.

If the SSI program is fully implemented under statehood, the maximum benefit payable in any year would be 50 percent of the per capita income of the state in the most recent year for which data are available. According to the Puerto Rican Planning Board, per capita personal income in Puerto Rico in the fiscal year ending June 30, 1989 was $5,266. The estimate assumes nominal per capita personal income in Puerto Rico in 1992 of $6,096 on an annual basis, or $508 per month. If the SSI program were fully in place in 1993, the maximum benefit would be 50 percent of this amount. However, under the phase-in of the SSI program in the statehood proposal, SSI benefits would be limited in 1993 to one quarter of the fully phased-in benefit, i.e., 12.5 percent of per capita income. The maximum SSI benefit would increase to 25 percent of per capita income in 1994, 37.5 percent in 1995, and 50 percent in 1996 when the program would be fully phased in. This estimate assumes a nominal annual growth rate in per capita personal income of 5 percent throughout the period covered by the estimate.

AFDC.—Statehood for Puerto Rico would have a relatively small effect on federal spending in the AFDC progam, as long as Puerto Rico did not raise its payment standards. CBO estimates that federal outlays would rise by $40 million in 1993 and $70 million a year during 1994–1996, as a result of a higher federal matching rate and a lifting of the current spending cap (See table on page 9). The federal matching rate would rise from 75 percent, where it is fixed for Puerto Rico under current law, to 83 percent, the rate Puerto Rico would have as a state, given its low per capita income. The federal matching rate in AFDC rises with a state's per capita income. By law, the federal share can be no less than 50 percent and no more than 83 percent. This rise in the federal matching rate would increase federal outlays by an estimated $10 million a year. Federal spending in Puerto Rico is also subject to an $82 million cap under current law (including spending on AABD and on foster care and adoption assistance). Lifting the cap would add $30 million to federal outlays in 1993 and an estimated $60 million in 1994–1996.

Current law AFDC outlays will rise significantly from 1993 to later years because Puerto Rico will have to implement an AFDC-Unemployed Parent (UP) program October 1, 1992, as required by the Family Support Act of 1988 (Public Law 100–485). Based on CBO estimates, about 35,000 AFDC–UP families will participate and federal costs will amount to about $60 million a year, when the program is fully effective in fiscal year 1994 and later. Without the lifting of the spending cap, Puerto Rico would have to absorb these additional costs. This accounts for the estimated increase in the costs of statehood between 1993 and 1994–1996.

If Puerto Rico increased its AFDC payment standards, costs of statehood for the AFDC program would be significantly higher than what CBO is estimating. For example, if Puerto Rico were to put one-half of its savings from the increased federal matching rate back into AFDC, federal outlays would rise by another $30 million a year in 1994 to 1996. In its 1987 study, GAO estimated that feder-

al outlays, as a result of statehood, would increase by $72 million a year, primarily from a doubling of AFDC payment standards. Whether Puerto Rico would raise its payment standards is uncertain. On the one hand, its standards are low and its sizable savings from expanded Medicaid coverage, along with the smaller savings in AFDC, could be used to pay for increased payment standards. On the other hand, uncertainties surrounding costs of the AFDC-UP program, possible increased benefits under the Nutrition Assistance Program with statehood, and concern over revenue losses under statehood would argue for caution in raising standards.

Foster Care.—Extending the IV-E foster care program to Puerto Rico would cost an estimated $3 million in 1993 growing to $5 million in 1996. This estimate assumes that foster care caseload in Puerto Rico grows at the same rate as in other states, that 60 percent of the Puerto Rican children in foster care would qualify for federal reimbursements under Title IV-E of the Social Security Act, that the current $100 monthly payment rate would be increased for inflation, and that the ratio of administrative to benefit costs would be the same as in the rest of the United States.

Earned Income Tax Credit (EITC).—Starting in 1993 Puerto Rican residents would become subject to U.S. income tax laws and as a result some residents would become eligible for the Earned Income Tax Credit. The estimated cost of the refundable portion of the EITC in Puerto Rico would be $5 million in 1993, $75 million in 1994 and $150 million in 1995 (See table on page 10).

The Census Bureau has published tables showing families with children under age 18 by 1979 income level for Puerto Rico and the United States. Under current law, families with children are eligible for EITC if their earnings and other income total $19,850 or less in 1989. After making adjustments for income and population growth between 1979 and 1989, there would be approximately 334,000 eligible families in Puerto Rico in 1989. This is approximately 5 percent of the U.S. families eligible in 1989. CBO assumed that the average benefit for Puerto Rican families would equal the average benefit for mainland families. Therefore, the estimated increase in federal outlays are 5 percent above current baseline estimates.

Tax Sharing ("Cover-over") Payments.—Some of the increased federal tax receipts from the repeal of the section 936 tax credit described in the next section would be returned to Puerto Rico as a so-called cover-over payment. If the increased federal receipts from repeal of the section 936 tax credit exceed the increased federal outlays from the expanded benefit programs discussed above, as CBO estimates, then all of the excess receipts in each year through 1995 would be transferred to the Treasury of Puerto Rico. We estimate these "cover-over" payments, classified as outlays in the federal budget, to total $48 million in 1993, $246 million in 1994 and $393 million in 1995. (See table on page 10).

Two other changes under the statehood alternative have completely offsetting effects on the federal deficit through 1995. Residents of Puerto Rico would become subject to U.S. income and excise taxes, phased in by 25% per year over the 1993-1996 period. The resulting increase in federal taxes would be returned completely to Puerto Rico's Treasury each year through 1995.

ESTIMATED FEDERAL OUTLAYS FOR DIRECT SPENDING UNDER THE STATEHOOD OPTION

[By fiscal year in millions of dollars]

	1993	1994	1995
Medicaid: Estimated outlays	200	550	900
SSI: Estimated outlays	160	290	400
AFDC: Estimated outlays	40	70	70
Foster Care: Estimated outlays	(1)	(1)	(1)
Earned income tax credit: Estimated outlays	5	75	150
Total Entitlement programs: Estimated outlays	405	985	1,520
Partial tax sharing ("cover-over") payment for section 936 tax credit: Estimated outlays	48	246	393
Tax sharing ("cover-over") payments for income and excise taxes: Estimated outlays	417	1,029	1,448
Total tax sharing ("cover-over") payments: Estimated outlays	465	1,275	1,841
Total direct spending: Estimated outlays	870	2,260	3,361

[1] Less than $5 million.

Revenues: The possessions tax credit, section 936 of the Internal Revenue Code, is available to U.S. corporations operating in Puerto Rico. Under the statehood alternative S. 712 would repeal the credit over a transition period of four years. The value of the credit would be reduce by 25 percent in 1993, 50 percent in 1994, 75 percent in 1995, and then the credit would be entirely repealed in 1996. According to estimates provided by the Joint Committee on Taxation, federal tax receipts would increase as a result by an estimated $453 million in 1993, over $1.2 billion in 1994, and over $1.9 billion in 1995.

ESTIMATED FEDERAL REVENUES UNDER THE STATEHOOD OPTION

[By fiscal year in millions of dollars]

	1993	1994	1995
Repeal of section 936 tax credit: Estimated revenues	453	1,231	1,913
New coverage of income and excise taxes: Estimated revenues	417	1,029	1,448
Total revenues	870	2,260	3,361

Senators and Representatives: Beginning January 1996, Puerto Rico would be represented in Congress by two senators and six representatives. At the same time, the office of Puerto Rico's current delegate to the Congress—the Resident Commissioner—would no longer be necessary. The costs of the additional members would be similar to the costs associated with members of Congress from the states with population size similar to Puerto Rico and of similar distance from Washington, D.C. Such costs would total about $7 to $10 million annually. The estimate for 1996 assumes the new members would be sworn in during January 1996.

Commission on Federal Laws in Puerto Rico: S. 712 would require the creation of a seven-person commission to examine the applicability of federal laws in Puerto Rico. The commission would be created within 60 days of confirmation of the election results (beginning November 1991 at the latest) and would have to submit its report by January 1, 1995. CBO estimates the cost of these activities would be $1 million anually in fiscal years 1992–1994.

Independence: If Puerto Ricans choose independence, Puerto Rico would become an independent republic upon proclamation. This option would provide for a Joint Transition Commission to facilitate a smooth and equitable transfer of power. Also, under independence the bill would provide for the continuation of current federal programs for a period of time. In addition the bill would phase-out the current tax sharing ("cover-over") payments of excise taxes to Puerto Rico. Finally, the bill would increase federal revenues by repealing the possessions tax credit and by collecting U.S. income taxes from Puerto Rican residents who remain U.S. citizens after independence is proclaimed.

Transition Commission: S. 712 would establish a Joint Transition Commission which would oversee the transfer of power from the United States government to the newly established Puerto Rican government. It is anticipated that the Commission would need to establish a number of task forces to handle various aspects of the transition. The costs of this Commission would be borne evenly between the U.S. and Puerto Rican governments. CBO estimates the cost to the federal government would be between $2 million and $3 million annually beginning in fiscal year 1992.

Current Federal Spending Programs: S. 712 would provide for the continuation of all federal programs until the end of the fiscal year in which independence is proclaimed. Beginning in the next year, a grant would be paid annually to the Republic of Puerto Rico in an amount equal to the total amount of grants, programs, and services provided by the federal government in such fiscal year. Payments of the grant would continue through the ninth year following certification of the referendum. Programs operating in Puerto Rico within the jurisdiction of the Senate Finance Committee would cease to exist in their current form, but would be included in the block grant. Also, the balance in the Puerto Rico "state" account in the federally administered unemployment trust fund would be transferred to the treasury of Puerto Rico at such time.

In addition, the bill would allow Puerto Rico to request renewal or continuation of any existing contractual obligations, provided that Puerto Rico agrees that the cost of such renewal or continuation shall be deducted from the annual grant. Also, all federal pension programs and Social Security benefits shall continue as provided by U.S. law. The accrual of additional coverage under the U.S. Social Security program, however, would not continue in Puerto Rico beyond December 31, 1996.

The bill does not address the date of proclamation, but it does state that the procedures for implementing the status option certified shall go into effect in October 1, 1991. The bill then outlines the procedures for implementing independence. The procedures are: (1) election of delegates to a constitutional convention, (2) development and adoption of the constitution, (3) ratification of the constitution, (4) election of officers of the Republic, and then (5) proclamation. The length of time any one of these events would take is uncertain. While most of these procedures have a time limit specified in the bill, the most significant one—the development and adoption of the constitution—does not. The time required to adopt a constitution could range from six months to several years. Based

upon discussions with people in Puerto Rico and the knowledge that the current constitution is found to be republican in form and in conformity with the constitution of the United States and has many of the qualifications specified in S. 712, CBO has estimated that a constitution could be adopted within one year. Based upon this assumption and other information in the bill, CBO assumes independence would be proclaimed in fiscal year 1993 if Puerto Ricans choose that option.

CBO estimates the total amount of grants, programs and services for Puerto Rico in fiscal year 1993 would be $3.8 billion. This estmate was developed by excluding Social Security, other Federal pension programs, salaries and wages, and procurement from the 1989 federal expenditures in Puerto Rico and adjusting for inflation.

The bill specifies that Social Security and other Federal pension programs would continue and therefore, would not be included in the block grant. The bill also specifies—subject to negotiation—the continued U.S. operation and use of military installations; therefore, no defense expenditures in Puerto Rico would be included in the block grant.

The savings to the federal government for fiscal years 1994 and 1995 would be the difference between the 1993 base amount and the 1993 grant adjusted for inflation through 1995. The estimated savings would be $0.2 and $0.3 billion in fiscal years 1994 and 1995 respectively. The cost to the federal government of transferring the balance of the Puerto Rican state account in the unemployment trust fund would be $1.1 billion in fiscal year 1994. In addition, employees in Puerto Rico would no longer collect unemployment benefits from the unemployment trust fund under this option. The savings to the federal government for unemployment benefits would be $150 million in 1994 and $160 million in 1995.

Tax Sharing ("Cover-over") Payments.—The tax sharing ("cover-over") payment for excise taxes that Puerto Rico currently receives would be phased out over the 1993–1996 period, resulting in reduced federal outlays. Under current law, federal excise taxes paid on Puerto Rican produced products are returned to the Treasury of Puerto Rico as a "cover-over" payment. Under independence, this so-called cover-over payment would be reduced by 20% in 1992, 40% in 1993, 60% in 1994, and 80% in 1995, and would be completely repealed in 1996. CBO estimates that this would result in reduced "cover-over" payments of $109 million in 1993, $163 million and $218 million in 1995.

ESTIMATED FEDERAL OUTLAYS FOR DIRECT SPENDING PROGRAMS UNDER THE INDEPENDENCE OPTION

[By fiscal year in millions of dollars]

	1992	1993	1994	1995
Block Grant: Estimated outlays	0	0	−200	−300
Unemployment trust fund balance: Estimated outlays	0	0	1,100	0
Unemployment compensation benefits: Estimated outlays	0	0	−150	−160
Total Federal benefit programs: Estimated outlays	0	0	750	−460

ESTIMATED FEDERAL OUTLAYS FOR DIRECT SPENDING PROGRAMS UNDER THE INDEPENDENCE OPTION—Continued

[By fiscal year in millions of dollars]

	1992	1993	1994	1995
Tax sharing ("cover-over") payment for excise taxes: Estimated outlays	−54	−109	−163	−218
Total direct spending: Estimated outlays	−54	−109	587	−678

Revenues: Under the independence option, S. 712 would repeal the section 936 tax credit according to the same transition schedule as under the statehood alternative. The value of the credit would be reduced by 25% in 1993, 50% in 1994, 75% in 1995, and then the credit would be fully repealed beyond 1995. The Joint Committee on Taxation estimates that this change would increase federal receipts by $453 million in 1993, over $1.2 billion in 1994 and over $1.9 billion in 1995, the same amounts as under the statehood alternative.

While Puerto Rican residents who remain U.S. citizens and continue to live in an independent Puerto Rico would become subject to U.S. income taxation, a relatively small amount of increased federal revenue is expected from this source for two reasons. First, in practice only high income earners would have positive tax liability, because of the exclusions for foreign-earned income allowed under current tax law. Second, Puerto Ricans with U.S. citizenship could give up their U.S. citizenship and thereby avoid the U.S. tax. The Joint Committee on Taxation estimates that the bill would raise $5 million in additional federal revenues in 1993, $7 million in 1994, and $8 million in 1995 from this source.

Under the independence option of S. 712, employers in Puerto Rico would no longer pay unemployment insurance taxes to the federal government. This would reduce federal revenues by an estimated $249 million in 1994 and $251 million in 1995.

ESTIMATED FEDERAL REVENUES UNDER THE INDEPENDENCE OPTION

[By fiscal year in millions of dollars]

	1992	1993	1994	1995
Repeal of Section 936 tax credit: Estimated revenues	0	453	1,231	1,913
Taxes on U.S. citizens in Puerto Rico: Estimated revenues	3	5	7	8
Unemployment taxes: Estimated revenues	0	0	−249	−251
Total revenues	3	458	989	−1,670

Enhanced Commonwealth status: Under the Finance Committee amendments, if Puerto Ricans choose an enhanced commonwealth, Puerto Rico would be treated similarly to U.S. states for certain entitlement programs. Nevertheless, these programs would be funded with 50 percent federal funds and 50 percent Puerto Rico funds. These programs also would be subject to similar phase-in requirements—25, 50 and 75 percent of full implementation costs—as under statehood. In addition, the bill would adjust "cover-over"

payments of excise taxes and customs duties to offset the additional federal costs of expanding the entitlement programs under the jurisdiction of the Senate Finance Committee. Finally, the bill would increase federal revenues by tightening the requirements for claiming section 936 tax credits. The "cover-over" payments would be increased or decreased by the U.S. Treasury accordingly to assure that the Finance Committee Amendment would be deficit neutral.

Under this option, the bill would establish a Caribbean Basin passport office and a Senate Liaison office. The bill also would provide for the consolidation of federal grant-in-aid programs except for programs under the jurisdiction of the Senate Finance Committee. Programs under the jurisdiction of the Senate Finance Committee would be established as discussed below.

Passport Office: S. 712 would require the federal government to establish a passport office in Puerto Rico for the Caribbean Basin. The State Department estimates the passport office will receive 50,000 applications per year. The cost estimate includes a one time $2.5 million cost to set-up, equip, and train office staff for the office. The annual operating expenses would be about $1 million annually. This estimate assumes 17 full-time federal employees.

Liaison Office: S. 712 would establish an Office of Senate Liaison for the Commonwealth of Puerto Rico to facilitate communications between the U.S. Senate and the Commonwealth. The bill would authorize an annual appropriation of $600,000 for salaries and $56,000 for office expenses. This estimate assumes that the Senate Liaison would be appointed by January 1992. CBO assumes that the entire appropriation will be spent in each year.

Current Federal Programs

Consolidated Grant.—If Puerto Ricans elect enhanced commonwealth status, section 501 of Public Law 95-134—Authorization, Appropriation-U.S. Territories—would apply to Puerto Rico. Section 501 allows a government agency to consolidate grants-in-aid other than direct payments to individuals for any fiscal year(s). The grant is not to be less than the sum of all grants which Puerto Rico is otherwise entitled. The grant is to be expended for purposes authorized, but Puerto Rico would be allowed to determine the proportion of the funds granted to be allocated to such programs and purposes. Each government agency must publish the method by which Puerto Rico may submit an application or a consolidated grant in the federal register. The agency may waive the requirement for an application with respect to a consolidated grant. CBO estimates there will be no additional costs for these programs with enactment of this bill.

Medicaid.—Under the commonwealth option, the current federal spending cap of $79 million per year would be eliminated and the Medicaid program would be funded with 50 percent federal funds and 50 percent commonwealth funds beginning in 1993. CBO assumed that Puerto Rico would not significantly alter the existing Medicaid program. Further, this estimate assumes 1.35 million participants. Under this option, the program would be phased-in as under the statehood option beginning in 1993 and would be fully implemented in 1996. In 1993, federal costs would be allowed to increase by 25 percent of the difference between current law costs

and the costs of an uncapped Medicaid program. The 25 percent would increase to 50 percent in 1994, to 75 percent in 1995, and to 100 percent in 1996. Under the commonwealth option, increased federal expenditures are estimated at $40 million in fiscal year 1993, $80 million in fiscal year 1994, $135 million in fiscal year 1995 and $195 million in fiscal year 1996.

Medicare.—The Medicare program would be treated the same under both the statehood option and the commonwealth option. As mentioned above in the statehood section, the Medicare program would continue as under current law until the Prospective Payment Assessment Commission has completed their assessment of the current Medicare system.

AABD.—Under the commonwealth option, Puerto Rico's Aid to the Aged, Blind and Disabled (AABD) program would be retained but minimum benefit levels would be established starting in 1993. The minimum benefit levels would be the same as the benefit levels applicable under the SSI program as it would be implemented under the statehood option. Under the commonwealth option, however, the AABD program would be funded with 50 percent federal funds and 50 percent commonwealth funds starting in 1993. Because benefit levels would be the same under either statehood or enhanced commonwealth status, we assumed the same number of participants under AABD as under SSI. Under the commonwealth option, federal expenditures for the AABD program would be approximately $80 million in fiscal year 1993, $150 million in fiscal year 1994, $200 million in fiscal year 1995, and $305 million in fiscal year 1996.

AFDC.—The federal matching rate for AFDC under the commonwealth option would be lower than under the statehood option—50 percent rather than 83 percent. Moreover, the 50 percent federal matching rate would be lower than the current-law matching rate of 75 percent, saving the federal government an estimated $30 million in 1993 and $40 million a year thereafter. As under statehood, the cap on federal spending would be removed, which would increase federal AFDC costs. As a result of changes in both the matching rate and the spending cap, federal costs would be essentially unchanged in 1993 and would rise by an estimated $20 million a year during 1994–1996.

Foster Care.—Federal foster care costs under the commonwealth option are estimated to be $2 million in 1993, rising to $3 million in 1996. Costs are $1 million lower than under the statehood option because the matching rate for maintenance payments would be 50 percent rather than 83 percent.

Tax Sharing ("Cover-over") Payments.—Existing tax sharing ("cover-over") payments for excise taxes and customs duties would be reduced by an amount necessary to offset the excess of increased outlays from the expended benefit programs above the increased revenue from the tighter section 936 credit requirement. CBO estimates that these tax sharing payments under current law would total $428 million in 1995, which would have to be reduced by $325 million under the commonwealth alternative to offset the increased outlays.

ESTIMATED FEDERAL OUTLAYS FOR DIRECT SPENDING PROGRAMS UNDER THE COMMONWEALTH OPTION

[By fiscal year in millions of dollars]

	1993	1994	1995
Medicaid: Estimated outlays	40	80	135
AABD: Estimated outlays	80	150	200
AFDC: Estimated outlays	(1)	20	20
Foster Care	(2)	(2)	(2)
Total Federal Benefit programs: Estimated outlays	120	250	355
Tax sharing ("cover-over") payments for excise taxes and customs duties: Estimated outlays	−120	−250	−325
Total direct spending: Estimated outlays	0	0	30

[1] Less than $500,000.
[2] Less than $5 million.

Revenues: Under the commonwealth option, the requirements for using the section 936 tax credit would be tightened, raising revenues. Under current law, in order to qualify for the section 936 tax credit, a corporation is required to earn at least 75% of its income from the active conduct of its trade or business in Puerto Rico. Under the commonwealth option, the required percentage would be increased in 1995 to 80%, and then increased further to 85% in 1996 and beyond. The Joint Committee on Taxation estimates that the tightened requirements for the section 936 tax credit would raise $30 million in federal receipts in 1995.

ESTIMATED FEDERAL REVENUES UNDER THE COMMONWEALTH OPTION

[By fiscal year in millions of dollars]

	1993	1994	1995
Tightening of requirements for claiming section 936 tax credit: Estimated revenues	0	0	30

6. Estimated cost to State and local government: The costs to state and local governments would vary considerably depending upon which status option is certified.

Under Statehood, Puerto Rico would incur significant savings in some entitlement programs. The AABD program would be replaced with the federally funded SSI program, and Puerto Rico would save $5 million annually. Currently, Puerto Rico spends $450 million on health care, and under Statehood and the extension of Medicaid, this estimate assumes Puerto Rico would spend $40 million on health care for a net savings of $410 million in benefit payments in fiscal year 1993. The savings would be $338 million and $266 million 1994 and 1995. Puerto Rico would save $40 million in 1993 and $70 million a year in 1994–1996 on the AFDC program. These savings would result from provisions in the bill that increase the federal matching rate and eliminate the cap on federal funds.

Under Independence, there would be savings to the federal government that could lead to costs for the government of Puerto Rico. It is unclear, however, to what extent Puerto Rico would pick up the difference in program spending.

Under Enhanced Commonwealth, the costs to Puerto Rico would be the required 50 percent match for the programs under the Fi-

nance Committee's jurisdiction. Currently, Puerto Rico spends $5 million annually on the AABD program. Under this option, they would spend $80 million in 1993 growing to $200 million in 1995. In AFDC, Puerto Rico would save $20 million a year during 1994–1996 from a combination of lowering the federal matching rate and eliminating the spending cap.

7. Estimate Comparison: None.

8. Previous CBO estimate: On September 6, 1989, CBO prepared an estimate of S. 712, The Puerto Rico Status Referendum Act, as ordered reported by the Senate Committee on Energy and Natural Resources. We also prepared a revised estimate of S. 712 as ordered reported by the Senate Committee on Energy and Natural Resources. This estimate is substantially different from the previous two estimates. This version of S. 712 would provide a 5-year transition under the statehood and commonwealth options for programs within the Finance Committee's jurisdiction. Also, this version provides for increased benefits under the commonwealth option at a 50 percent federal matching rate for those programs under the Senate Finance Committee's jurisdiction. And, this estimate combines the costs of S. 712 as ordered reported by the Energy and Natural Resources, except for Food Stamp program costs, with the cost of this bill.

9. Estimate prepared by: Mark Booth, Alan Fairbank, Maureen Griffin, Terri Gullo, Jim Hearn, Lori Housman, Julie Isaacs, Cory Leach, Marta Morgan, Janice Peskin, and Patrick Purcell.

10. Estimate approved by: C.G. Nuckols for James L. Blum, Assistant Director for Budget Analysis.

V. Changes in Existing Law Made by the Committee Amendment

In the opinion of the Committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill as amended and reported by the Committee on Finance).

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